INTERNATIONALIZATION

of the Securities Markets

Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce

July 27, 1987

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

July 29, 1987

The Honorable John D. Dingell
Chairman
Committee on Energy & Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

I am pleased to transmit the Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce on the Internationalization of the Securities Markets. The report is a comprehensive examination of a number of areas relating to internationalization, including transnational secondary market trading; the application of distribution, disclosure and accounting standards to international offerings; the regulation of broker-dealers, investment companies, and investment advisers who operate in more than one country; economic trends affecting internationalization; and the impact of global trading on jurisdictional issues and enforcement efforts.

The report, which was prepared by the staff, has not been reviewed by the Commission and does not represent the Commission's views. The staff anticipates that the Commission will utilize the report in formulating its recommendations in the area of internationalization.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

Enclosure

cc: The Honorable Edward J. Markey
The Honorable Norman F. Lent
The Honorable Matthew J. Rinaldo

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

July 29, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing &
  Urban Affairs
SD 534 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Chairman Proxmire:

I am pleased to transmit the Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce on the Internationalization of the Securities Markets. The report is a comprehensive examination of a number of areas relating to internationalization, including transnational secondary market trading; the application of distribution, disclosure and accounting standards to international offerings; the regulation of broker-dealers, investment companies, and investment advisers who operate in more than one country; economic trends affecting internationalization; and the impact of global trading on jurisdictional issues and enforcement efforts.

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cc: The Honorable Donald W. Riegle, Jr.
    The Honorable Jake Garn
    The Honorable William L. Armstrong

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GLOSSARY

American Depositary Receipt - a negotiable certificate, usually issued by a United States bank, denominated in shares, certifying that a stated number of securities of a foreign issuer has been deposited with a depositary (a United States bank or its foreign affiliate or correspondent).

American Depositary Share - a security, evidenced by an American Depositary Receipt, that represents a foreign security or a multiple or fraction thereof which foreign security has been deposited with a depositary.

Asiadollar Bond (see Eurobond)

Bearer Instrument - a negotiable instrument for which ownership is transferred by change of physical possession. The bearer is the legal owner of such instruments.

Big Bang - the term used to describe the change in the regulatory structure of the London securities markets. The major changes involved: removal of restrictions on foreign ownership of United Kingdom securities firms (March 1986); unfixing of commission rates for trades on the London Stock Exchange (now the International Stock Exchange) and abolition of the broker/jobber segregation (October 27, 1986); and implementation of the Stock Exchange Automated Quotation (SEAQ) System, a new screen-based trading system (October 27, 1986). Also, part of the development of a new United Kingdom regulatory structure was the enactment of the Financial Services Act, which establishes the Securities and Investments Board (SIB), requires authorization thereby of all self-regulatory agencies, and requires membership of all members of the securities industry in such a self-regulatory agency or direct registration with the SIB (November 1986).

Blind Brokering Screens - video display screens that show real-time quotation and trade information for United States government securities. The screens are owned by government securities brokers who limit access to the screens to primary and aspiring primary dealers. A primary dealer wishing to effect a trade must call the inter-dealer broker to consummate the trade and only the inter-dealer broker knows who is the <u>contra</u> party to the trade; thus, the system is a "blind" trading system.

Book-entry - electronic entries on the computerized records of United States registered clearing agencies that represent clearing agency participants' securities positions with the clearing agency. It is also used to refer to a method of settlement (<u>i.e.,</u> book-entry settlement) that permits clearing agency participants to settle trades by instructing

the clearing agency to debit or credit their accounts at the depository by electronic entry.

Bulldog Bonds - foreign bonds issued in the United Kingdom (see also Foreign Bonds).

Clearance and Settlement - the completion and settlement of financial transactions and an agreement between parties as to terms and conditions.

Clearing Agencies - associations of banks or brokers that provide facilities and services relating to the settlement of securities transactions between their members on a prescribed basis.

Closed-end Funds - investment funds that issue only a limited number of shares, which therefore may be purchased only from current owners.

Common Prospectus Approach - designed to facilitate multinational offerings, this approach would require all participating countries to agree on disclosure standards for an offering document that could be used in two or more of the countries (see also Reciprocal Approach).

Continuous-net-settlement System - an accounting system used by United States registered clearing agencies that summarizes and nets each participant's daily transactions in each issue, including previous open positions, to create a single long position or a single short position.

Convertible Currency Bonds - bonds which give the owner the right to convert payments of interest and/or principal into another currency, often at predetermined exchange rates and conversion dates.

Credit Controls - government controls over national money and credit policies, credit and money supplies and interest rates. These controls can affect the quantity and cost of credit available to domestic and foreign borrowers in the country's capital markets, and can strongly influence the direction of the national economy.

Currency Swaps - agreements between two counterparties to exchange specific amounts of one currency for another and to re-exchange the currencies at a specific time in the future. The swaps are designed to occur at a predetermined rate of exchange, usually based on the spot rate of the two currencies as of the beginning of the swap period (see also Interest Rate Swaps).

Delivery-versus-payment - a method of securities settlement in which the buyer (or the buyer's agent) receives purchased securities from the seller (or the seller's agent) only against full payment for the securities.

Dual Currency Bonds - long-term securities denominated in two currencies. The most common types have been bonds with initial and interim coupon payments in a non-dollar currency such as Swiss francs or yen, and a fixed final principal payment in United States dollars (see also Foreign Currency Bond).

Equity Related Bonds - bonds that have both a debt and an equity component, e.g., convertible bonds and bonds with equity warrants.

Eurobond - debt security issued multinationally through an international syndicate of banks or securities firms in a currency other than that of the country in which the bond is issued. The all-inclusive term has several derivatives and variations, such as Eurodollar bond, Euroyen bond, Euro-DM bond, etc., that indicate the currency in which the offering is denominated; and Asiadollar bond, etc., which indicates the primary geographic area of the offering (see also Foreign Bond and International Bond).

Eurocommercial Paper - short-term, unsecured debt taking the form of promissory notes and issued in the same manner as Eurobonds.

Eurocredits (see Syndicated Loans)

Eurocurrency Market - the market for deposit liabilities, denominated in a currency other than that of the country of the bank in which the deposit is made.

Eurodollar Securities (see Eurobond)

Euroequity - Euroequities include common and preferred stocks distributed to investors in one or several markets outside the issuer's domestic market by a syndicate of international securities firms and banks.

Euromarket - the generic, all-inclusive term refers to all types of markets other than strictly domestic and foreign markets (see Eurobond, Eurocommercial paper, Eurocurrency market, Euroequity and Euronotes).

Euronotes - the term refers to short-term paper issued in the Euromarket similar in most respects to commercial paper except that it is issued pursuant to a facility of medium-term

duration. A Euronote facility provides a guarantee to the issuer for placement of its short-term paper for the period of its duration.

European Currency Unit (ECU) - an artificial currency unit comprising a "basket" of the currencies of nine members of the European Economic Community. The value of an ECU vis-a-vis a specific currency is determined according to specific weightings of the participating currencies.

Euroyen Securities (see Eurobond)

Financial Forward Contracts - individualized contracts requiring delivery at a future date of an agreed amount of one currency for another (see also Financial Futures Contracts).

Financial Futures Contracts - standardized contracts to buy or sell a "basket" of financial assets at a specific price and date in the future. Financial Futures are usually traded on an exchange, and settlement is usually made by net cash transfer rather than actual delivery of the financial assets. Examples of Financial Futures include interest rate futures, currency futures, and Treasury bond futures (see also Financial Forward Contracts).

Floating Rate Notes - notes (usually unsecured) paying interest at rates adjusted from time to time to correspond to the yield on a selected money market indicator, such as Treasury bills or LIBOR.

Foreign Currency Bonds - bonds whose proceeds are payable in a currency other than the domestic currency of the issuer (see also Dual Currency Bond).

Foreign Bond - debt security issued in a country other than that of the issuer, sold through a syndicate of banks or securities firms located primarily in the country of distribution, and denominated in the currency of that country (see also Eurobond; International Bond).

Foreign Exchange Market - the international market in which currencies are traded. The market performs several functions, including facilitating the transfer of purchasing power from one currency into another; the provision of credit for international commercial transactions; and provision of a means by which exposures to risks of exchange rate fluctuations may be minimized. Transactions in foreign exchange include those in the spot, forward, swap, option and futures markets.

Grey Market - in the Eurobond context, the grey market is similar to a "when-issued" market. This grey market occurs

when members of the selling group and underwriters supply an issue at discount rates prior to the actual offering date. Such a market would be unlawful in the United States. The term also refers to portions of certain domestic markets that are relatively less strictly regulated than the major markets of those countries, or those in which unconventional securities are sold.

Interest Rate Swaps - agreements between two counterparties to exchange interest payment flows of differing character arising from an underlying notional principal amount. The three main types are coupon swaps (fixed rate to floating rate in the same currency), basis swaps (one floating rate index to another floating rate index in the same currency), and cross-currency interest rate swaps (fixed rate in one currency to floating rate in another) (see also Currency Swaps).

International Bond - debt security that is issued originally outside the country of the borrower. These usually take the form of Eurobonds or foreign bonds (see also Eurobond; Foreign Bond).

International Capital Markets - one of the two subsets of the international financial markets. The term refers to all securities issued in the Euromarket or in a foreign market and that have a duration of over one year.

International Equity Market (see Euroequity)

International Financial Markets - an all-encompassing term which refers to all international or multinational markets for short-, medium- and long-term securities and loans, forward and swap contracts, financial futures and foreign currencies. Those portions of the international financial markets dealing with securities are divided into two subsets depending on the maturity of the instrument involved (see also International Capital Markets and International Money Markets).

International Money Markets - one of the two subsets of the international financial markets. The term refers to all securities issued either in the Euromarket or in a foreign market and that have a duration of one year or less.

LIBOR - London Interbank Offered Rate. This is the deposit rate offered for interbank loans within London. Variations on the term include LIBID, or the London Interbank Bid Rate which is the interest rate at which bids for interbank loans are made. The midpoint of the spread between LIBOR and LIBID is commonly referred to as LIMID.

Merchant Banks - banks that engage in a combination of investment banking and commercial (but not usually retail) banking functions. While prominent in Europe, for legal and historic reasons they are generally not found in the United States.

Multilateral Development Institutions - generally banks, such as the World Bank and the Asian Development Bank, that participate in international capital markets both as borrowers and as lenders to developing nations.

Netting - the process of offsetting expected deliveries of securities against expected receipts of the same securities. United States registered clearing agencies provide this service to their participants and generate for each participant one net settlement obligation per securities issue per day, rather than multiple delivery and receipt obligations in the same security.

Note Issuance Facilities (see Euronotes)

Open-end Mutual Funds - funds that redeem shares at net asset value and set no limit on the number of shares available for public sale, usually selling as many shares as possible.

Privatization - the sale of state property or enterprises to private business or investors. Generally privatizations have involved the distribution of shares to a wide number of investors (see also State Enterprises).

Queues - as a result of the process whereby monetary authorities restrict access to national capital markets, queues are formed when issuers "line-up" to distribute their securities.

Reciprocal Approach - designed to facilitate multinational offerings, this approach would require the agreement of each participating country that an offering document used by the issuer in its own country would be accepted for offerings in each of the other countries (see also Common Prospectus Approach).

Revolving Underwriting Facilities (see Euronotes)

Samurai Bonds - foreign bonds issued in Japan (see also Foreign Bond).

Securitization - the broad process whereby capital financing occurs through securities issuance rather than bank financing.

Securitized Asset Pools - assets pooled and sold as securities, either in the form of debt or equity-related instruments, to provide liquidity for the issuer's financial assets.

State Enterprises - property and industries owned by a national government (see also Privatization).

Swaps (see Currency Swaps and Interest Rate Swaps)

Syndicated Loans - bank credits extended by a group of banks in a given country or in different countries, often to nonresident borrowers.

Universal Banks - financial institutions such as those found in Germany and France which generally do not separate the investment and commercial banking functions.

Yankee Securities - foreign bonds issued in the United States (see also Foreign Bond).

CHAPTER I

INTRODUCTION */

Internationalization of the securities markets is not a new phenomenon. Throughout much of history investors have assumed the risks attendant to investing in a foreign economy. The degree to which the world's securities markets have become internationalized, however, is unprecedented. These developments are a result both of technological advances and of the removal of restrictions on foreign participation by many of the world's securities markets.

For example, the increase in the number of bonds issued internationally has grown dramatically in the last six years. In 1980, the total amount of bonds issued internationally was approximately $38 billion. Last year, that figure was $254 billion. Of that amount almost $44 billion was raised by U.S. issuers. Last year, U.S. investors' transactions in foreign equity securities reached a record $102 billion, while foreign investors purchased and sold approximately $277 billion in U.S. equity securities.

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*/ This report was prepared by the staff of the Securities and Exchange Commission. The report has not been reviewed by the Commission and does not represent the Commission's views. The staff report is the first of a two-part effort. The staff anticipates that the Commission will utilize the staff report in formulating its views on policy and legislative initiatives in the internationalization area.

With these new opportunities come new challenges. The laws governing the securities markets of various countries are diverse. Indeed, there are significant differences among the regulations in different nations, in terms of nature, purpose, and degree of protection. Issuers seeking to raise capital in more than one country may face significant problems in complying with requirements in different markets. Investors may be confused by the lack of comparability in disclosure standards and unaware of the risks of investing outside of their domestic securities markets. In addition, the ability to move capital quickly across national boundaries and to engage in securities transactions through off-shore entities provides new mechanisms for the unscrupulous to engage in securities fraud, and presents new obstacles for law enforcement agencies.

The House Committee on Energy and Commerce and the Senate Committee on Banking, Housing and Urban Affairs directed the Securities and Exchange Commission to conduct a study of the issues raised by the accelerating internationalization of the securities markets. This report by the Commission's staff concludes the first part of that study.

The Commission's Directorate of Economic and Policy Analysis ("DEPA") has conducted an extensive study of the movement of capital in the last decade. Chapter II of the report discusses the results of that study, which focuses on the economic, institutional and regulatory forces shaping the process of internationalization.

The U.S. securities markets have influenced the trend toward internationalization. This influence has resulted from the relatively large size of the U.S. economy and from the ability of U.S. markets to adapt to changing circumstances. At the end of last year, the market capitalization of U.S. equity securities totalled approximately $2.6 trillion or about 43% of the world's total stock market capitalization.

Internationalization also has been marked by increasing competition among the world's securities markets, as the staff study reports. For example, measured in U.S. dollars Japan's markets grew at an annual rate of 23% from 1978 to 1986, Italy's grew 39%, and the United Kingdom's markets grew at an annual rate of 18%. By comparison, the U.S. equity market grew 14% annually during this period. Moreover, in the last two years, the Japanese markets grew at an annual rate of 68% as compared with 22% for U.S. markets. Even when the decline in the value of the U.S. dollar is taken into account, the Japanese equity market grew by 34% between 1984 and 1986.

The U.S. markets have served as a model for foreign markets by developing new products and by promoting competition among market professionals. Chapter II discusses recent developments in a number of other countries that emulate the American markets. For example, in the United Kingdom brokerage commissions have been deregulated only within the last year; the United States deregulated them in 1975. In addition, financial products such

as standardized options, securitized asset pools and financial futures, all of which are well-established in the United States, are just being introduced around the world.

This chapter concludes with an analysis of the impact that internationalization has had on the U.S. markets. In 1980, U.S. corporations raised about 12% of their public debt financing abroad. By 1986, 22% of U.S. corporate bond financings were being conducted abroad. Last year, as noted, U.S. investors purchased and sold over $100 billion in foreign stocks and foreign investors traded a record $277 billion in U.S. domestic equity securities. Foreign investment by U.S. private sector pension funds has also increased dramatically from an estimated $3.3 billion in 1980 to approximately $45 billion in 1986. At the same time, however, the number of foreign equities traded on U.S. exchanges has remained relatively static, as has the amount of foreign issues of stocks and bonds registered with the Commission for sale in the United States. While foreign debt and equity issues offered in the United States have increased significantly in absolute terms from approximately $4.4 billion in 1981 to $6.4 billion in 1986, they have remained relatively stable as a percentage of the total debt and equity issued in the United States due to the tremendous growth in those issues over the last five years.

The third chapter of the report, prepared by the Division of Corporation Finance, examines disclosure and distribution issues relating to international offerings of securities. The

international capital markets provide mechanisms by which individuals and institutions are able to participate in highly diversified financial investment vehicles. Corporation Finance's chapter details the procedural aspects of bringing a Eurobond issue to market, including marketing considerations, organization and timing, and the nature of disclosure and investor protection available in that market.

With respect to international issues of equity securities, the report notes that the mechanisms that have for many years been utilized in offering debt instruments internationally are now being mobilized for the purpose of placing shares of major corporations through an international network, sometimes called the Euroequity market. This growing market reflects the desire of large corporations to issue their equities internationally in order to obtain a broad shareholder base and to realize a price that is more representative of international market demand for the corporation's shares. The chapter examines a number of open issues in the Euroequity market including the nature of investors in that market and the development of a secondary market for equity securities apart from the home market. The study notes that when the home market is the only viable secondary market for a large multinational issue, securities may flow back to that home market soon after they are issued, depressing the share price.

The chapter summarizes the U.S. distribution and disclosure requirements and their application to international issues of

securities. The chapter also provides a comparative picture of the securities regulations of the European Economic Community and eight countries with substantial securities markets: the United Kingdom, Japan, Canada, the Federal Republic of Germany, France, Australia, Switzerland, and the Netherlands. A detailed description is provided of the statutory scheme and regulatory authority in each nation; also discussed are the nature of the securities markets and the issuers, the types of securities traded, the nature of both the primary and the secondary market, liability provisions, and other regulatory requirements.

A similar comparative discussion is provided for tender offer regulation in the U.S. and the eight countries mentioned above. The section also discusses certain disclosure and other compliance issues encountered by foreign bidders in complying with U.S. tender offer regulation. The study notes that U.S. law may apply not only to a foreign bidder making an offer for an American corporation, but also to an offer for a foreign corporation's securities if the securities are held in the United States. In order to avoid application of U.S. law, foreign bidders on occasion have taken precautions to prevent the extention of the tender offer to U.S. citizens or residents. In some cases, this has deprived those U.S. investors of an opportunity to participate in the premium offered in the tender offer. Foreign bidder objections to making offers in the U.S. appear to center on the financial disclosure requirements and the Securities Act registration requirements where securities

are offered in exchange for the target's shares. Conflicts also may arise where foreign law forbids the disclosure of certain information required to be disclosed pursuant to U.S. law.

The chapter concludes with an examination of two important current issues, the jurisdictional reach of the registration provisions of the Securities Act and direct access to U.S. capital markets by foreign issuers. The study notes that the extraterritorial application of the registration provisions has resulted in the use of complex and costly offering procedures to avoid such provisions, resulting in exclusion of U.S. persons from investment opportunities. The study discusses a possible alternative approach based on the territorial application of the registration provisions. With respect to access to U.S. markets by foreign issuers, the chapter notes the reluctance of some foreign issuers to participate in the U.S. capital markets and that this reluctance may force U.S. investors who want to trade foreign securities to do so off shore. This could adversely affect the ability of U.S. markets to compete with foreign markets as well as result in additional costs to U.S. investors.

In examining issues relating to internationalization, the Commission issued a concept release seeking comments on several approaches for the registration of specified foreign securities. One approach would allow use of the offering document required in an issuer's home country as the prospectus for offerings in the United States. If such a reciprocal approach were to be used, key questions to be addressed would include the countries that

should be included, the classes of issuers that may participate, and the types of securities that may be issued. The comparability of accounting and auditing standards will be an important consideration in determining the jurisdictions to be included. In its release, the Commission proposed to proceed initially with the United Kingdom and Canada because the disclosure and accounting practices of those countries are most similar to those of the United States, and because U.S. investors are relatively familiar with those countries' standards. Alternatively, the release proposed a common prospectus approach. This approach would entail an agreement that an offering document meeting certain disclosure standards could be used in two or more of the three countries.

A majority of commentators endorsed the Commission's initiative. Although many believed the common prospectus approach to be the ideal, a majority favored some type of reciprocal approach as the one most easily implemented.

It is widely recognized that differences in accounting and auditing standards present significant problems for the development of international markets. These differences present road blocks to issuers seeking to raise capital outside their home market. They also create difficulties for investors attempting to evaluate the economic merits of investments in the securities of corporations whose financial statements have been prepared and audited according to different standards. Chapter IV of the report, which was prepared by the Office of the Chief Accountant,

discusses the differences in accounting principles and auditing standards in a number of countries, concentrating on differences caused by the method by which such standards are promulgated. In general, the staff study indicates that where there is a wide dispersal of corporate ownership, accounting principles tend to be established by the accounting profession and reflect the financial status of the entity for which the financial statements were prepared. By comparison, where ownership is concentrated, accounting principles are more likely to be set by governmental agencies, in which case countervailing policies (for example, the need to collect tax revenues) may affect the depiction of financial status. The chapter also describes the various efforts under way by international accounting associations to harmonize auditing and accounting standards.

Commission rules permit a foreign issuer, with certain exceptions, to prepare its financial statements according to accounting principles that are generally accepted in the issuer's home country. If there are material differences between such principles and generally accepted accounting principles in the United States, the financial statements must include a reconciliation of these differences. With respect to auditing standards, however, the Commission's staff seeks assurance that the examinations of financial statements by foreign auditors are as extensive and complete as those conducted by U.S. auditors. In this regard, the staff requires foreign auditors to demonstrate that the

accounting firm is professionally qualified and in good standing in the jurisdiction where its offices are located, that its professional staff is knowledgeable about U.S. accounting and auditing standards as well as Commission rules and other pronouncements, and that U.S. auditing standards and the Commission's rules have been followed in connection with the particular audit. Generally, this is demonstrated by the foreign issuer's employment of an accounting firm currently practicing before the Commission as a consultant or co-auditor.

Included in the chapter is a comparative study of accountant liability provisions in four countries: Canada, the United Kingdom, Australia and Japan. The study indicates that, for the most part, laws relating to accountant liability in these countries are similar and that generally some type of due diligence defense is available to accountants.

The Division of Market Regulation has prepared a comprehensive report on the international secondary markets, set forth in Chapter V. The report describes the secondary trading market in Eurobonds as a model of a major, integrated multinational securities market. Trading in this $3.5 trillion market is centered in London. Trades are executed over the counter by telephone among a network of members of the Association of International Bond Dealers ("AIBD"), a voluntary self-regulatory organization. In 1986, the Council of AIBD Reporting Dealers was formed to establish trading and reporting obligations for AIBD dealers.

With respect to international equity markets, the Division notes that, while there are now more than 500 companies whose shares are listed and traded outside their home countries, trading is limited, particularly with respect to U.S. securities. Very little foreign trading in U.S. securities occurs during U.S. trading hours, and broker-dealer firms indicate that the trading in U.S. securities overseas occurs almost entirely among foreign investors and sophisticated U.S. institutional investors. Recent developments, however, particularly the deregulation of markets in the United Kingdom, suggest that the degree of worldwide competition in equity securities may increase in the future.

The chapter describes the operations of multinational securities firms and the methods by which such firms conduct trading in the markets of several nations. This section of the chapter focuses on regulatory concerns in overseeing large multinational firms actively conducting a securities business in many different countries, particularly the difficulties in ensuring the financial integrity of these firms. Although the staff is not presently aware of specific problems, the increased internationalization of securities markets has raised concerns about the ability of the Commission and the U.S. self-regulatory organizations ("SROs") to ensure the financial integrity and responsibility of U.S. registered broker-dealers. These concerns arise, in part, because the Commission and the SROs lack authority to examine and regulate the activities of unregistered overseas affiliates.

With respect to foreign broker-dealers transacting business in the U.S., the Commission's staff has not required broker-dealer registration in all instances within the jurisdictional reach of the Securities Exchange Act. Where exceptions have been made to accommodate international trading, however, the necessary predicate has been adequate protection for investors and the integrity of the U.S. markets. For example, on April 21, 1986, the Commission approved a pilot program jointly undertaken by the National Association of Securities Dealers ("NASD") and the International Stock Exchange ("ISE") that makes certain market information, including securities quotations by market makers, available in both the United Kingdom and the U.S. Shortly thereafter, the Division of Market Regulation took a temporary no-action position to allow quotes of foreign market makers entered into the ISE's automated quotation system to be disseminated in the U.S. through the NASD system, and trades resulting from those quotes to be executed without either the foreign market maker or the International Stock Exchange registering as a broker-dealer.

Another imporant recent development has been the establishment of market linkages between U.S. and foreign stock exchanges. The Commission approved the first such trading link in 1984, between the Montreal Stock Exchange and Boston Stock Exchange. The first trading link between a primary U.S. market and a primary foreign market was approved in 1985, between the American Stock Exchange and the Toronto Stock Exchange. At this time,

trading is limited to the 34 dually listed securities shared by the two exchanges and usage has been relatively low. In the future, the exchanges anticipate that they will seek Commission approval to expand the list of eligible securities to include those traded on either exchange. A linkage between the Midwest Stock Exchange and the Toronto Stock Exchange also has been approved. In reviewing these trading linkages, the Commission has required that adequate provision be made for the sharing of enforcement and surveillance information and that any exchange seeking to link with a U.S. exchange have the ability to discipline its members for violations of its rules governing trades made through the linkage.

The lack of international clearance and settlement links to facilitate cross border settlements, and the existence of widely varying clearance and settlement systems within national markets, are significant problems. The Division discusses the problems in international clearance and settlement and the linkages that have developed between national clearance and settlement systems.

This chapter concludes with an examination of some recent Commission initiatives. The Commission recently approved rule proposals submitted by the American and New York Stock Exchanges to enable the exchanges to waive or modify certain corporate goverance and financial disclosure listing standards for foreign companies. The rule changes permit the exchanges to consider a foreign company's compliance with the laws, customs, and practices of the country of its domicile, in determining whether the company

has complied with otherwise applicable listing standards. A similar proposal by the NASD was approved at the same time. Further, at a public meeting on May 9, 1986, the Commission considered comments received in response to its earlier release on the internationalization of the trading markets. The Commission endorsed the view of commentators that it should proceed cautiously in responding to the growth of transnational trading. The Commission instructed the staff to facilitate the development of international linkages between securities markets and clearing agencies and to ensure that such linkages incorporate adequate market surveillance and information sharing arrangements.

The next chapter of the report, prepared by the Division of Investment Management, describes the effects of internationalization on investment companies and investment advisers. The Division reports that participation by U.S investment companies and advisers in foreign and international markets has increased significantly. The number of domestic open-end investment companies that emphasize foreign securities in their portfolios has nearly tripled since 1983 and the total assets of these firms have grown from $3.5 to over $15 billion in that time. Over 120 investment advisers from 20 countries have registered with the Commission. At the same time, it has become more common for investment companies registered in the U.S. to issue their securities in foreign markets. This is due in part to the relaxation by some countries of regulations designed to discourage foreign

investment as well as to the increased popularity of collective investment vehicles with individual investors in foreign markets.

Participation by foreign investment companies in U.S. markets has been limited by Section 7(d) of the Investment Company Act. That Section prohibits an investment company that is not organized under the laws of the U.S. or a state of the U.S. from publicly offering its securities in this country unless it first obtains an order from the Commission. The Commission is authorized to issue an order permitting such sales only if it finds that (1) by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce effectively the provisions of the ICA against the foreign company, and (2) the issuance of an order is consistent with the public interest and the protection of investors. Commission rules require that, to obtain such an order, the fund's assets and records must be kept in the U.S., the fund's by-laws and charter must contain, in substance, certain provisions of the ICA and be enforceable in the U.S., and a majority of the fund's officers and directors must be U.S. citizens (with a majority of these citizens resident in the U.S.). At present, only five investment companies are operating in the U.S. pursuant to an order under Section 7(d). In 1984 the Commission recommended to Congress that it amend Section 7(d) to broaden the Commission's exemptive authority with respect to foreign investment companies. The staff has also been studying the possibility of recommending a reciprocal approach to investment company registration based on either a

Directive of the EEC relating to collective investments or the Standard Rules for the Operations of Institutions for Collective Investment in Securities promulgated by the Organization for Economic Cooperation and Development ("OECD").

This chapter also describes recent steps taken by the Commission to facilitate the offering of foreign bank securities in the U.S. On September 10, 1986, the Commission proposed Rule 6c-9 which would permit a foreign bank or its finance subsidiary to offer or sell its debt securities or non-voting preferred stock in the U.S. without registering as an investment company if certain requirements are met. At present, a foreign bank seeking to sell its securities in this country must register as an investment company or obtain an exemptive order from the Commission.

The final chapter in the staff's report discusses issues concerning the enforcement of the U.S. securities laws in a global securities market. Chapter VII, written by the Division of Enforcement and the Office of the General Counsel, notes that the internationalization of the securities markets has provided expanded opportunities for fraud as well as for legitimate investment activities.

The chapter begins with a discussion of the jurisdictional reach of the U.S. securities laws. In general, the courts have held that U.S. law applies whenever conduct takes place in the U.S. or conduct occurring abroad has subtantial effects in this country. Although the American Law Institute's recently revised

Restatement of the Foreign Relations Law of the United States departed from these theories, the ALI made changes, after discussions with the Commission's Office of the General Counsel, to bring the Revised Restatement closer to the existing case law.

The remainder of the chapter is devoted to an examination of the problems in conducting an investigation of possible violations of the U.S. securities laws where evidence is located abroad; several recent insider trading cases are described to illustrate the problems. In particular, the staff has found that blocking statutes, by which foreign governments prohibit or control the distribution of information, and secrecy laws, which establish rights by which individuals may require others to keep secret specific information, may create obtacles to the Commission's efforts to obtain information. Swiss laws protecting the confidentiality of information furnished to banks by their customers have been particularly problematic in insider trading investigations.

To overcome these and other difficulties, the staff has relied on international agreements, including treaties and memoranda of understanding. The U.S. has four treaties providing for mutual assistance in criminal matters: The Treaty Between the U.S. and the Swiss Confederation on Mutual Assistance in Criminal Matters, the Treaty on Mutual Legal Assistance with the Kingdom of the Netherlands, the Treaty with the Republic of Turkey on Extradition and Mutual Assistance in Criminal Matters and the Treaty Between the Italian Republic and the United

States on Mutual Assistance in Criminal Matters. Several other treaties have been negotiated but are not yet in force. Although these treaties primarily apply to criminal matters, the Commission is able to utilize them in connection with its civil enforcement of the securities laws because willful violation of these laws is a criminal offense.

The U.S. has also entered into a Memorandum of Understanding with the Swiss government to provide assistance to the Commission to investigate insider trading violations. The memorandum was recently used for the first time in an insider trading case to obtain the identity of a customer of a Swiss bank who traded in advance of the merger between two U.S. companies. In addition, the Commission has entered into memoranda of understanding with the United Kingdom and Japan.

The Commission and its staff also participate in several international organizations concerned with the internationalization of the securities markets and attendant enforcement problems. For example, the Commission is a member of the International Organization of Securities Commissions and chairs its working group on the exchange of enforcement information. In addition, last fall the Commission proposed that a working group of the OECD conduct a survey of OECD member countries concerning mutual assistance and cooperation in securities enforcement matters. That survey is under way.

In studying the internationalization of the securities markets as directed by the Committees of Congress and in preparing

the fields of law, economics and accountancy. In addition, the staff engaged in extensive original research, interviewing and consulting with individuals and entities that participate in the international securities markets or are otherwise knowledgeable in areas relating to internationalization. The staff consulted with securities professionals, academics, economists, accounting and law firms, government agencies, and private organizations. The staff also had the benefit of the responses made by commentators to three releases issued by the Commission on the subject of internationalization. Additionally, the Roundtable on Internationalization, held by the Commission on February 17, 1987, provided valuable information. Participants included experts on many different aspects of internationalization.

The staff's report should serve as a description of the rapid and multifaceted changes that are taking place in the world's securities markets. The report also identifies numerous issues raised by the unprecedented rate of internationalization and describes Commission initiatives over the past few years to respond to these issues. The staff anticipates that the report may be utilized by the Committees and by the Commission to examine possible legislative, rulemaking or policy initiatives to deal with internationalization.

CHAPTER II

Factors Affecting the Trend Toward Internationalization of the Securities Markets

Prepared by the Directorate of Economic and Policy Analysis

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Chapter II

FACTORS AFFECTING THE TREND TOWARD INTERNATIONALIZATION OF SECURITIES MARKETS

A. Introduction

Chapter II provides empirical evidence of the nature and extent of the internationalization of securities markets and a framework for understanding the economic, institutional and regulatory factors which are shaping the process of internationalization. The chapter begins with an overview of emerging trends in international capital formation followed by a discussion of the role played by the U.S. market in shaping the global markets in securities. Next, there is a review of regulatory trends which are influencing the international capital formation process and an in-depth examination of the international bond and equity markets. Finally, there is an analysis of portfolio investment flows and the impact of internationalization on the U.S. securities markets.

The world's securities markets play a much larger role in international capital formation than they did just a few years ago. This trend has manifested itself in a number of distinct ways. In the 1980's there has been an explosive growth in bonds issued internationally. Between 1980 and 1986 international

bond issues increased from $38.3 billion to $225.4 billion. 1/ In 1986, U.S. issuers alone raised a record $43.7 billion through international bond issues. And foreign issuers tapped the U.S. bond market for $6.1 billion.

International markets also have been used to raise equity capital more frequently in recent years. Euroequity offerings of common and preferred stock amounted to $11.8 billion in 1986 compared to only about $200 million as recently as 1983. Last year foreign corporations -- primarily Canadian issuers -- raised $2.3 billion in equity capital in the U.S. market through public offerings registered with the SEC. Today the international markets are a significant source of capital for private corporations, governments, and multilateral development institutions such as the World Bank.

The global character of the securities markets is also reflected in the rapid growth of transactions by U.S. and foreign investors in markets outside the investor's home country. The rapid increase in the number of U.S. mutual funds investing on

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1/ International bond issues are negotiable debt securities (subject to market transactions over-the-counter or on an exchange) with a maturity of one year or more and do not include short-term notes or Eurocommercial paper. International bonds are usually defined as consisting of two types -- Eurobonds and foreign bonds. Eurobonds are offered simultaneously in the capital markets of at least two countries by an international syndicate while foreign bonds are placed in the domestic market of a single country by a syndicate composed of institutions located in the country where the bonds are offered. See discussion in this chapter, Section E.

a global basis is a further indication of this trend. A recent development that has become an important part of the global market in securities is the use of closed-end funds listed on U.S. stock exchanges to invest exclusively in the securities markets of specific foreign countries. Today there are at least twelve such funds with investments directed to a particular foreign market. There are also about 60 U.S. open-end funds that invest on a global or on a regional basis such as in the emerging markets of Asia.

U.S. investors' purchases and sales of foreign stocks reached a record $102.0 billion in 1986, while foreign investors' activity in U.S. domestic corporate stock was a record $277.6 billion. And these trends have been even more pronounced with respect to transactions in debt securities. A substantial increase in international portfolio investments has also occurred in other major capital markets around the world as European and Japanese investors have increasingly made portfolio investments on a global basis. 2/ Pension funds -- particularly those based outside the U.S. -- and other institutional investors have sought to diversify their portfolios by investing internationally. As a result, larger amounts of capital are crossing national borders as investors throughout the world increase their purchases of foreign securities.

2/ International portfolio investments are discussed in Section J of this chapter. In particular, see note 96, *infra*.

International diversification provides a means to pursue risk reduction strategies that could not be achieved by domestic investment alone. This has become particularly prevalent as the capitalization of foreign stock markets has grown relative to the U.S. markets. In view of the uneven growth rates in the world's economies, investment in foreign markets also may provide opportunities for higher rates of return than might be available in a home market.

These trends in the primary and secondary markets have been facilitated by a series of recent liberalizations in capital market regulations in several industrialized countries. This has greatly expanded the potential for international capital mobility. Nevertheless, the internationalization of securities markets is not new. 3/ An American economist observed in 1930 that, even in the early decades of the 19th century, U.S. securities accounted for a large portion of trading on the London Stock Exchange and a major technological improvement -- the opening of the Atlantic cable in 1886 -- greatly facilitated international arbitrage

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3/ The economic development of the United States was fostered by foreign investment. From colonial days on, Americans have purchased securities in foreign markets. By the 1860's, foreign issues were being floated in the American capital market and, by 1906, American investors were estimated to hold approximately $600 million of foreign securities. See Harold G. Moulton, George W. Edwards, James D. Magee, and Cleona Lewis, Capital Expansion, Employment and Economic Stability (Washington, D.C.: The Brookings Institution, 1940).

between New York and London as communication across the Atlantic was reduced from days to minutes. 4/ So, even 100 years ago, technological improvements in communications were already influencing international trading in securities. But the great depression of the 1930's and World War II greatly reduced opportunities for further integration of international capital markets.

Thus, while internationalization of securities markets is not new, the rapidity of its growth in the 1980's is unique. Vast amounts of capital are now being raised internationally; the world's economies are more interdependent; and economic, technological and regulatory changes are altering the international financial landscape in an unprecedented manner.

B. Emerging Trends In International Capital Formation

In the 1970's and 1980's the world's capital markets were strained by significant macroeconomic events that resulted in greater volatility in interest rates, inflation and exchange rates. Large shifts in global investment preferences occurred following the dramatic fluctuations in world oil prices. These events, which occurred over relatively short periods of time, spawned financial innovation as market participants sought to cope with changes in the world's capital markets.

4/ The Work of the Stock Exchange, J. Edward Meeker (Revised ed.; New York: The Ronald Press, 1930), page 503.

In the 1980's the trend has been toward the use of international securities markets as a means of capital formation and away from reliance on international bank loans. 5/ This trend toward the securitization of international capital flows is illustrated in Table II-1. The Bank for International Settlements ("BIS") estimates that net bank lending in international markets peaked in 1981 at a record $165 billion. At that time, capital raised through international bonds, net of redemptions and retirements, amounted to only $32 billion. Since 1981, net international bond offerings have grown at a compound annual rate of 37 percent. But net international bank lending has not again achieved the level reached in 1981. More capital was raised through international bond issues during 1985-86 combined than was raised through international bank loans. The 1980's have

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5/ For a more complete discussion of the trend toward securitization in international capital markets see, for example, the following reports prepared by the Bank for International Settlements ("BIS"), the International Monetary Fund ("IMF") and the Organization for Economic Cooperation and Development ("OECD"): BIS Fifty-Sixth Annual Report (Basel, June 9, 1986), pages 61-108; Recent Innovation in International Banking, Chapter 5, "The Trend Toward Securitization", BIS (April 1986) (hereinafter, BIS International Banking Study); Financial Market Trends, OECD (Paris) June 1986, Volume 34, pages 5-9 and pages 41-65, and Volume 35, November 1986, pages 5-8 and pages 24-76); International Capital Markets Development and Prospects, Occasional Paper No. 43, IMF (Washington, D.C.: February 1986) (hereinafter, IMF Occasional Paper No. 43), pages 24-27 and 58-69; and International Capital Market Developments and Prospects (World Economic and Financial Surveys), IMF (Washington, D.C.: December 1986) (hereinafter, IMF Study of International Capital Markets, December 1986).

Table II-1

NET NEW BORROWINGS IN INTERNATIONAL MARKETS
(US $ Billions)

Year	Net Bank Lending (1)	Net Bond Issues (2)	Minus: Double Counting (3)	Net Bank and Bond Financing
1978	$ 90.0	$ 29.0	$ 6.0	$113.0
1979	125.0	28.5	7.5	146.0
1980	160.0	28.0	8.0	180.0
1981	165.0	32.0	7.0	190.0
1982	95.0	58.5	8.5	145.0
1983	85.0	58.0	13.0	130.0
1984	90.0	83.0	28.0	145.0
1985	105.0	125.0	55.0	175.0
1986	$160.0	$156.0	$76.0	$240.0

Note: (1) Excludes double counting due to redeposits among reporting banks; (2) net of redemptions and repurchases; (3) certain bonds taken up by BIS reporting banks and bonds issued by reporting banks to facilitate their international lending activities.

Sources: BIS Annual Reports; 1981 page 100, 1986 page 87, and 1987 page 94

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also witnessed the emergence of a rapidly growing Euroequity market which has been facilitated by the increase in stock prices in most of the world's stock markets. 6/

Several economic factors have contributed to the re-emergence and unprecedented growth in the 1980's of the international securities markets. Reduced inflation contributed to the desire by investors, particularly institutional investors, to hold bonds

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6/ Euroequity offerings amounted to $11.8 billion in 1986. The growth of the Euroequity market is discussed in this chapter, Section H.

or equities rather than bank deposits. 7/ The sharp decline in long-term interest rates made refinancing of existing long-term debt attractive. Although precise data is not available, it is estimated that about 28 percent of international bond offerings in 1986 represented refinancing of existing debt rather than new money raised in the capital markets. 8/ The debt repayment problems experienced by some developing countries also have had an impact on international capital markets by placing a greater emphasis on the need for liquidity and marketability of assets. This has resulted in banks relying on the issuance of long-term securities as a means to strengthen their capital base. Banks have been major participants in the growth of the international bond markets -- both as issuers of securities and as underwriters and dealers in securities.

Financial innovation also has contributed to the greater reliance on the international securities markets for capital formation. This is evidenced by the development of securities products designed to meet the needs of both issuers and investors.

7/ During the 1976-1985 period, the percent of gross financial assets held by the non-financial private sector in the form of bonds, equities and institutional investments (i.e., mutual funds, pension funds, trust and insurance company funds of a non-depository nature) increased relative to deposits in the United States, Japan, Germany, the United Kingdom and Canada. See BIS Annual Report, 1986, op. cit., page 69.

8/ It is estimated that in 1986 early redemptions of international bond offerings amounted to $41.1 billion and scheduled repayments totaled $23.3 billion. See Financial Market Trends, Volume 36 (February 1987), op. cit., page 56.

Floating rate notes, which are close substitutes for syndicated bank loans, were the fastest growing Eurobond instrument in the early 1980's. Floating rate notes grew from 12 percent of new Eurobond issues in 1980 to over one-third by 1985. 9/ The volume of floating rate notes in the U.S. dollar sector of the Eurobond market actually exceeded fixed rate issues for the first time in 1985. In 1986, however, floating rate notes declined in importance compared to fixed rate Eurobonds due to the relatively attractive terms that became available in the fixed rate sector as interest rates declined to their lowest level in nearly a decade. 10/ In the first quarter of 1987, floating rate issues accounted for only six percent of the value of Eurobond offerings. 11/

Financial innovation has been particularly evident in the dollar sector of the Eurobond market. As regulatory restrictions have been relaxed in other currency sectors of the Eurobond market and in a number of foreign domestic capital markets, financial innovation has been facilitated in those markets as well. The growth during the past few years in the use of interest rate swaps and currency swaps is perhaps the best example

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9/ BIS International Banking Study, *op. cit.*, page 134.

10/ See Financial Market Trends, Volume 35 (November 1986), *op. cit.*, page 29, and Volume 36 (February 1987), pages 57-59.

11/ International Capital Markets Review, Volume II, No. IV, (New York: Securities Industry Association, April 24, 1987), page 1.

of the influence of product innovation on capital market development. 12/ But this would not have been possible without the liberalization of capital market regulations in a number of countries.

The 1980's have also witnessed the development of a short-term Euromoney (notes and commercial paper) market. The issuance of Euronotes rose from $9.5 billion in 1983 to $27.0 billion in 1986. While the value of Euronotes declined in 1986 from the record level achieved in 1985, the volume of newly arranged Euro-commercial paper programs and of other similar instruments exploded from $21.8 billion in 1985 to $65.2 billion in 1986. 13/

12/ An interest rate swap is a contract entered into by two parties who agree to pay each other interest payments (often one based on a fixed rate and one on a floating rate) on a notional amount for a specified period, generally ranging from 2 to 10 years. The notional amount is the amount on which the interest payments are calculated. The interest rate swap takes advantage of disparities in the premium for credit risk demanded by the fixed and floating rate markets. Similarly, a currency swap is an agreement to exchange payment or receipt of principal and interest in one currency for payment or receipt of principal and interest in another currency. The currency swap is used to transform assets or liabilities denominated in one currency to those of another currency.

13/ Euronotes are short-term paper, typically with three or six month maturities issued by borrowers in their own names and backed up by commercial bank underwriting commitments. Other terms for euronotes, often associated with particular organizations or banks, include Euronote facilities and note issuance facilities. Another short-term instrument is non-underwritten Eurocommercial paper. Eurocommercial paper programs closely parallel commercial paper issuance in the U.S., and is usually done without an underwriting facility. The issuance of Eurocommercial paper is a recent development in the Euromoney market. See Financial Market Trends Volume 37 (May 1987), pages 79-83; and Recent Innovations in International Banking (April 1986), pages 29-36 and 255-270.

C. Unique and Influential Role of U.S. Securities Markets

The U.S. capital markets' influence on other markets -- both foreign and international -- appears to have been substantial. In general, the U.S. regulatory system has allowed financial innovation to take place -- both in the U.S. domestic securities market and in the dollar sector of the Eurobond market. This has facilitated the operational efficiency of our securities markets and international capital mobility. The rapid maturation of the other securities markets, however, presents new challenges and opportunities resulting from increased competition for new issues placement and in secondary market trading in both domestic and international issues.

At the end of 1986 the market capitalization of U.S. equities totaled $2.6 trillion or about 43 percent of the world's stock market capitalization. This is down from 56 percent just two years ago. As seen in Table II-2, the next largest, Japan's, was about two-thirds the size of the U.S. The appreciation of the yen relative to the U.S. dollar and the strong growth of the Japanese stock market have both contributed to the rapid growth in the capitalization of the Japanese equities market. The equity capitalization of most other major markets has been growing faster (measured in U.S. dollars) than the U.S. market. Besides Japan's equity markets which grew at a compound annual rate of 23 percent from 1978 to 1986, the fastest growing equity markets have been

Table II-2

MARKET CAPITALIZATION OF WORLD'S STOCK MARKETS
(US $ Billions)

Country	1978	1980	1982	1984	1985	1986
United States	$ 870	$1,391	$1,481	$1,714	$2,160	$2,556
Japan	327	357	410	617	909	1,746
United Kingdom	118	190	182	219	328	440
Germany	83	71	69	78	179	246
Canada	67	113	105	116	147	166
France	45	53	29	40	79	150
Italy	10	25	20	23	65	141
Switzerland	41	46	41	43	90	132
Australia	27	60	41	52	63	78
Netherlands	22	25	22	31	52	73
All Others	75	141	125	133	172	267
TOTAL	$1,685	$2,472	$2,525	$3,066	$4,244	$5,995

Note: Data are estimates of exchange-listed stocks with market value of investment companies excluded. U.S. data includes NASDAQ stocks. Data excludes foreign corporations, except for the NASDAQ portion of the U.S. market during the years 1978 to 1982.

Source: SEC Monthly Statistical Review (various issues)
NASDAQ Fact Book (various issues)

Italy's (39 percent), the United Kingdom's (18 percent) and France's (16 percent). By comparison, the U.S. equity market grew 14 percent annually during this period. 14/

The growth of foreign equity markets relative to the U.S., in part, reflects the maturation of many overseas markets. At the same time, however, it should be recognized that the capitalization of the U.S. market relative to foreign markets has been affected by the large volume of retirements of corporate stock. Net new corporate stock issues (gross financing minus redemptions) in the U.S. have been negative in five out of the last six years. As a result, over this period, the value of new issues has not been sufficient to offset retirements of corporate stock. 15/

In the last two years these growth trends have been influenced by the sharp decline in the value of the U.S. dollar relative to other currencies. The market capitalization of U.S. stock markets grew at an annual rate of 22 percent from 1984 to 1986. During this same period, the Japanese equity market grew by 68 percent measured in U.S. dollars and by 34 percent when measured

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14/ For the United States, Table II-2 shows the market capitalization of all domestic stocks listed on U.S. stock exchanges or traded on NASDAQ ("National Association of Securities Dealers Automated Quotatation System"). Similar trends have occurred with respect to equity trading volume measured in U.S. dollars. Appendix Table II-G sets forth data on stock market share volume and turnover for the world's major stock markets (the ten countries with the largest stock markets).

15/ "From National to International," James M. Davin, The NASDAQ Handbook, Chapter 3 (Probus Publishing, Chicago, 1987).

in yen. Likewise, measured in U.S. dollars, the market capitalization of the German and Swiss stock markets grew by 78 and 75 percent, respectively, between 1984 and 1986. When measured in marks and francs the stock markets of Germany and Switzerland both grew by 39 percent. While currency realignments have had a large impact on the growth rates of some stock markets outside the U.S., the growth in foreign stock markets measured in local currencies has been impressive. This, of course, has contributed to increased investor interest in markets outside the U.S.

A broader view of the size and depth of the U.S. securities markets is given in Table II-3 which shows the amount of new debt and equity capital raised by governments, private non-financial enterprises, financial institutions and foreign issuers. In 1986, all issuers raised $812 billion in capital through securities issued in the U.S. In Japan, the next largest market, issuers raised slightly more than one-half this amount, $438 billion. Ten years ago the proportions were roughly the same with issuers raising $206 billion in the U.S. and $89 billion in Japan. In most of the major markets, national and local governments raise the greatest portion of capital in the securities markets. In the U.S., federal, state and local governments accounted for 63 percent of all new issues in 1986. In other markets, such as Germany and Japan, financial institutions which directly assist their

Table II-3

GROSS NEW ISSUES IN THE CAPITAL MARKETS
OF TEN MAJOR COUNTRIES: 1986

	Total U.S. $ Billions	Percent of Total			
		Central/ State Gov't.	Private Enter- prises 1/	Financial Insti- tutions 2/	Foreign Issues
ited States	$812	63%	18%	18%	1%
pan	438	43	12	44	1
aly	126	77	13	10	*
rmany	126	30	5	65	0
ance	68	34	31	35	*
ited Kingdom	33	63	23	11	2
itzerland	34	4	11	15	69
nada 3/	57	58	–	–	*
stralia 4/	28	90	6	4	0
therlands	$ 12	51%	6%	41%	1%

Insignificant (less than 1%)
This category includes all non-financial business.
This category includes both government and privately-owned institutions.
The "Private Enterprises" and "Financial Institutions" figures are combined for Canada totaling 42 percent.
Table shows 1985 data for Australia.

urces: OECD Financial Statistics; Bank of Canada Review, March 1987; Year Book Australia, 1986; Reserve Bank of Australia Bulletin, March 1987; Directorate of Economic and Policy Analysis

national governments in raising capital are major issuers in the market. 16/

The U.S. has by far the largest bond market in the world in terms of par value outstanding. Domestic publicly traded bonds totaled $3.7 trillion and the U.S. represented 47 percent of the world's total in 1986. Japan, with $1.5 trillion in bonds outstanding, accounted for 19.7 percent of the total while Germany with about $800 billion had 10.9 percent. 17/

The dominant position of the U.S. securities markets can be explained, in part, by the size of our gross national product which is double and even triple that of the other leading economies of the world. The separation of the investment and commercial banking sectors also may have given impetus to the development of the U.S. securities market. 18/ It is interesting to

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16/ In 1986 France had the highest proportion of total capital raised by private non-financial enterprises, 31 percent. France was followed by the United Kingdom and the U.S. with 23 and 18 percent, respectively. The significant privatization activity in France played a large role in the increased new issue activity in the French capital markets last year.

17/ Prospects for Financial Markets in 1987, Henry Kaufman and Jeffrey Hanna, Salomon Brothers Inc., Research Department (December 16, 1986), page 22.

18/ David Gil, Director, Capital Markets Department, International Finance Corporation, presents an interesting comparison of institutional structures of financial markets in his speech "Take Off Time for Thailand's Capital Market," Bangkok, November 28-29, 1984. Also, see OECD Report: The Committee on Financial Markets International Trade In Services: Securities (Paris, 1987), pages 13-15.

note that the two largest securities markets, the U.S. and Japan, which account for nearly three-quarters of the world's equity markets capitalization generally have maintained a separation of commercial banking from investment banking.

The U.S. securities markets and its regulation appear to have influenced the shape of other markets. Many securities instruments were first introduced in the U.S. securities market and are now being introduced around the world. U.S. securities firms maintain a sizable presence in most international financial centers. NYSE member broker-dealers had in 1986, for example, 48, 36, and 27 sales offices in the United Kingdom, Canada and Germany, respectively. In the United Kingdom, the number of U.S. sales offices increased to 48 in 1986 from 37 in 1982. 19/

A considerable dynamic for change was initiated in the U.S. in the early 1970's with the gradual deregulation of brokerage commission rates on stock exchange transactions. 20/ When

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19/ The International Market: Growth in Primary and Secondary Activity, Jeffrey M. Schaefer and David G. Strongin, Securities Industry Association, July 1987.

20/ As a result of a mandate from Congress pursuant to Section 6(e)(3) of the Securities Exchange Act of 1934, the Securities and Exchange Commission's economics staff monitored very closely the results of the decision to deregulate commission rates on stock exchange transactions. See, for example, Fifth Report to Congress on the Effects of the Absence of Fixed Rates of Commissions, Securities and Exchange Commission (May 26, 1977) and Staff Report on the Securities Industry in 1980, Directorate of Economic and Policy Analysis, Securities and Exchange Commission (September 1981), pages 81-112.

legislation passed in 1975 that completed the process, the U.S. securities industry moved into a much more competitive era. Other countries, such as Canada, started to reduce commission rates on large orders fairly soon thereafter. The process of unfixing commission rates was not completed until 1983 in Canada, 1984 in Australia and 1986 in the United Kingdom. 21/

The quotation and transaction systems which have become an important market medium in the U.S. are being used increasingly in other markets such as Japan, the United Kingdom and Singapore. In addition, automated execution systems for small orders which were introduced in U.S. stock markets in response to the deregulation of commission rates are now being offered in other markets around the world. And the U.S. stock markets were among the first to develop linkage among their stock exchanges and to forge linkages between domestic and foreign stock markets. Innovation has also occurred in clearance and settlement. Since 1980, several U.S. clearing agencies have pursued settlement linkages with their foreign counterparts. The linkage of these clearing agencies

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21/ In Canada negotiated rates were introduced April 1, 1983. In Australia negotiated rates on orders in excess of A$100,000 began April 1, 1984. In the United Kingdom negotiated rates were introduced on October 27, 1986 as part of the "Big Bang. See The Wardley Guide to World Money and Securities Markets, by Lynette Kemp; Euromoney Publications (1984), pages 29, 30, 78-80, 384-387 (hereinafter, The Wardley Guide).

facilitates the settlement of securities transactions and reduces the costs and problems associated with physical delivery.

The regulatory climate in the U.S. has permitted our securities markets to become a leader in financial innovation. New financial instruments are now being introduced in foreign markets with increasing frequency. 22/ Trading of standardized options began in the U.S. in 1973. In 1975, Canada and in 1976 Australia followed suit with their own programs. The Netherlands started the European Options Exchange in 1978. For seven years this was the second largest market for standardized options. The United Kingdom also introduced standardized options to their markets in 1978 and became the second largest options market in 1985. France, Switzerland and Japan are planning to initiate options trading. These countries also are developing markets for the trading of financial futures. 23/

22/ Propects for Financial Markets in 1986, Salomon Brothers, Inc. (December 18, 1985), pages 34-38.

23/ For a more complete discussion of options and futures trading in the countries cited here see the Euromoney Supplement "Futures Options," October 1986, specifically for Australia (page 63), Canada (page 79), Netherlands (page 46) and the United Kingdom (page 43). France is scheduled to begin options trading in September 1987 (see Financial Times, June 25, 1987, page 35). Japan is scheduled to initiate options trading in 1988 (see Japan Economic Journal, June 13, 1987, page 5). The U.S. began trading financial futures in 1975, the United Kingdom in 1981, Australia in 1983, Canada in 1984, Japan in 1985 and France in 1986. It is interesting to note that recently the trading volume of the

(footnote continued on next page)

The innovative nature and level of sophistication of the U.S. capital markets is also indicated by the wide range of securities instruments traded actively in the U.S. market. Table II-4 shows the availability of five broad categories of securities instruments in the world's major capital markets. These instruments are important in providing investors, institutions, traders, investment bankers and issuers a broad range of vehicles to manage their assets. Only the U.S. has a highly developed market in all five categories. Japan and the United Kingdom have highly developed markets for three of the five instruments. The other countries have two or fewer. 24/

Japan, has the world's second largest equities market and the second largest currency sector in the Eurobond market. The growth of the domestic corporate bond market, nevertheless,

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(footnote 23 continued from previous page)

futures contract in the Japanese government bond, their only futures contract, has exceeded the trading of the leading U.S. government bond contract. This high volume for a single contract is expected to change when other contracts are introduced in the Tokyo futures market. See "The Japanese Market-Hedging Lifts the Five Day Contract," Financial Times (London), March 19, 1987, Section III, page V.

24/ The classification of the five categories of securities instruments into three levels of development (high, intermediate and low) is explained in Table II-4. With the rapid liberalization of several of the major securities markets the classification will have to be revised frequently.

Table II-4

THE DEVELOPMENT OF CAPITAL MARKET INSTRUMENTS
IN THE WORLD'S MAJOR SECURITIES MARKETS

Capital Market Instruments

Countries	Government Bonds	Corporate Bonds	Corporate Equities	International Bonds 1/	Options and Futures 2/
U.S.	H	H	H	H	H
Japan	H	I	H	H	L
United Kingdom	H	I	H	H	I
Germany	H	L	I	H	L
Canada	H	I	H	I	I
Switzerland	I	I	H	H	L
France	I	L	I	L	L
Italy	H	L	I	L	L
Australia	H	I	H	I	I
Netherlands	H	I	I	I	I

H = A highly developed market exists in which new issues, securities outstanding and trading volume are substantial when compared to the economy's gross national product.

I = The market has developed to an intermediate level where new issues, securities outstanding and trading volume are of moderate size when compared to the economy's gross national product.

L = The market has developed only to a limited exent which may be due to the recent introduction of the product or a market does not yet exist.

1/ International bonds include foreign bonds and various currency sectors of the eurobond market.

2/ Only four countries have both a market in standardized options and financial futures: Australia, Canada, the United Kingdom and the U.S. The U.S. is the only one with both markets highly developed.

Note: The classification of the government bond, corporate bond, corporate equity and international bond markets is based on a combination of objective factors. The three prime ones are the annualized dollar volume of new issues over several recent years, the dollar amount of issues outstanding, and the rate of turnover in the secondary market. These data are used as a percent of gross national product. For options and financial futures other factors are considered — for example, how recently the market opened, how many different contracts are being traded and the dollar equivalent of the trading volume.

Source: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

appears to have been hindered by regulations. 25/ The size of the corporate bond market is an anomaly since the liquidity available domestically is enormous. In response to pressures from both domestic and foreign issuers, the Japanese Ministry of Finance has eased conditions lately in the corporate bond market. For example, the number of companies that are allowed to issue unsecured bonds or convertible debt nearly doubled. 26/

Japan has permitted limited financial futures trading. Participation in this trading, though, has been restricted as of early 1987 to securities firms for their own accounts. 27/ With regard to options, a market does not yet exist.

The United Kingdom's domestic corporate bond sector has not kept pace with its equities market. This was primarily due to economic and business factors in the United Kingdom. 28/ In recent years, however, the number of new corporate debt issues has increased.

25/ For a discussion of recent efforts by the Ministry of Finance to liberalize regulations in the Japanese domestic market and the yen currency sector of the Eurobond market, see Section D of this chapter.

26/ About 170 firms are now permitted to issue unsecured bonds and 330 can issue convertible debt. "Foreign Players Allowed Into Medium-term Game," Financial Times (London), April 21, 1987, page VIII; and "Japanese Utilities Switch to Euro-issues," Financial Times (London), April 24, 1987, page 29.

27/ "Tokyo May Lift Ban on Futures Trading," Financial Times, (London), April 1, 1987, page 31.

28/ The Wardley Guide, op. cit., pages 368-373.

As noted earlier, the United Kingdom began trading standardized options in 1978 and initiated trading in financial futures in 1981. The development of the options market has progressed to a point where the London International Financial Futures Exchange reached an agreement with the Chicago Board of Trade which will allow investors to open options contracts in the one market and close it in the other. 29/

The U.S. securities markets are also unique in their regulations governing disclosure, insiders and intermediaries, accompanied by a flexibility that has permitted competition and innovation. The U.S. prohibits insider trading and has vigorous enforcement. U.S. regulation also requires the purchasers of corporate securities to register their ownership (conducted almost entirely by transfer agents and brokers). In many countries the bearer form of securities issuance is practiced, especially for bonds.

Regulation of new issue and periodic disclosure in the U.S. places considerable emphasis on extensive financial reporting. The disclosure program, including related procedures and potential legal liabilities may, however, serve as a disincentive to the issuance of foreign bonds and equity securities in the U.S. capital market. U.S. regulation emphasizes full disclosure

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29/ "Chicago Plans New Futures Trading Link," Financial Times (London), February 10, 1987, page 1,

rather than merit regulation which seems to play a much larger role in some other capital markets. Recent modifications to the disclosure program have placed more emphasis on the continuous reporting of corporate issuers. 30/ In the U.S. broker-dealers are also closely regulated regarding trading practices, customer protections and financial solvency. The supervision of broker-dealers and trading markets is primarily conducted by self-regulatory organizations ("SROs") such as the exchanges and the NASD under the oversight of the SEC.

The U.S. capital markets are rather flexible and open. New securities products and services are introduced generally without significant regulatory delays. In fact, competition is encouraged by the regulatory framework and, was mandated by the Securities Acts Amendments of 1975. Moreover, foreign securities firms participate in a full range of investment banking and securities activities. 31/

30/ In February 1982 the SEC adopted rules that comprehensively revised the disclosure system combining features of the new issues disclosure program with those of the continuous disclosure program. This is commonly referred to as the integrated disclosure system, a simplified, less burdensome disclosure system for domestic and foreign issuers of securities. See Securities Act Release No. 6383, March 22, 1982.

31/ The Department of the Treasury has studied the national treatment foreign banking and securities firms face in most of the countries discussed in this study (Natonal Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations, 1986 Update, December 18, 1986; hereinafter referred to as "National Treatment Study, 1986 Update"). Of particular note is that as of year-end 1985 there were an estimated 75-100 broker-dealers in the U.S. with foreign parents and 35 foreign-owned members of the New York Stock Exchange.

D. Regulatory Trends in International Capital Markets

The world's securities markets have not been subject to uniform regulation. New international bond issues -- with the notable exception of the U.S. dollar sector -- historically has been subject to regulatory controls regarding the "size and maturity of individual issues, the quality of borrowers, the number and amount of issues per calendar period and/or formal issues calendars." 32/ Capital market controls appear to have been utilized primarily to achieve macroeconomic policy objectives. Sometimes, however, they have been used to protect domestic financial institutions from competition from foreign institutions in the underwriting and distribution of securities. There is a clear trend, however, toward a restructuring of the regulatory framework to facilitate competition and greater mobility of capital across national boundaries.

In the U.S., the Interest Equalization Tax was abolished in 1974. Commission rates on stock exchange transactions were deregulated in 1975. At the same time, the passage of the Securities Acts Amendments of 1975 encouraged greater competition among U.S. securities markets. It also mandated that the SEC facilitate the development of a national market in securities. This was followed in the 1980's by the deregulation of interest

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32/ Financial Market Trends, Volume 22 (June 1982), op. cit., page 24.

rates on bank deposits. These events were followed by a series of regulatory initiatives in capital markets around the world.

The changes that occurred in London have received the greatest attention. The so-called "Big Bang" in October 1986 resulted in the deregulation of brokerage commissions, the restructuring of the London stock market and greater access by foreign participants to the domestic securities markets of the United Kingdom. It can be expected that the events in London will continue to have an impact on other capital markets. Both France and Canada, for example, are in the process of restructuring their securities markets. 33/ Regulatory changes also are occurring in Tokyo and

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33/ In addition to removing restrictions on foreign ownership of Canadian securities firms, Canadian financial service firms (securities firms, banks, trust companies and insurance companies) will be permitted to offer a wider range of financial products. In France, the stock market is in the process of being opened to foreign firms and to domestic financial institutions whose access to the market has been restricted. Brokers who traditionally have had a monopoly on stock trading will be permitted to diversify into investment banking and other activities. By 1988, members of the Bourse will be able to form partnerships with foreign and local firms and French brokers will be able to opt for becoming investment bankers under the French banking laws and still retain their membership in the Bourse. And a wider range of financial products has been approved. In February 1986, a financial futures market was established. An options market on French stocks opens at mid-year 1987. See "Foreign Brokers Ready to Blast Off in Toronto," Chicago Tribune, June 22, 1987, page 3; "The Four Pillars Are Shaken," Financial Times, London, June 30, 1987, page 22. BIS Fifty-Seventh Annual Report, Basil, June 15, 1985, pages 81-84; and "La Mutation des Bourses Francaises" a Press Conference Speech by Xavier DuPont (Member of the Commission des Operations de Bourse) to the Compagnie des Agents de Change on March 10, 1987.

in other financial centers. 34/

In recent years, the liberalization of regulations regarding exchange controls, market access and financial innovation has facilitated the growth of the international bond market. 35/ The international bond market consists of Eurobonds and foreign bonds. Eurobonds are placed simultaneously in the capital markets of at least two countries. Eurobonds are normally denominated in a currency which is not the currency of the country where the bonds are offered and may even consist of several currencies. Eurobonds are issued in bearer form through international syndicates composed of investment, merchant or commercial banks of several countries. Typically, these financial institutions maintain a substantial international presence in London, New York, Tokyo and other major financial centers through a network of subsidiaries, affiliates or branch offices.

Foreign bonds are sometimes referred to as traditional international issues because the markets for foreign bonds existed long before the Eurobond market developed in the mid-1960's. Foreign bonds are placed in the capital market of a single country by a

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34/ See, for example, "Internationalization of Securities Market," Securities Market in Japan, Chapter IX (Tokyo: Japan Securities Research Institute, 1986); and The World Economy and Financial Markets in 1995 - Japan's Role and Challenges (Tokyo: Nomura Research Institute, March 1986).

35/ For a comprehensive listing of specific regulations in OECD member countries that affect international capital flows, see Financial Market Trends, OECD, Paris, various issues.

syndicate composed of institutions located in the country where the bonds are offered. But quite often the syndicates include the domestic subsidiaries of multinational financial institutions that provide investment banking services on a global basis. Foreign bonds are usually denominated in the currency of the country in which the issue takes place; occasionally, however, they have been denominated in a foreign currency.

In the United Kingdom, the financial markets are in the process of adjusting to the implementation of the recently enacted Financial Services Act. 36/ The Act is intended to protect investors in securities and related financial products "against insolvent, dishonest, or incompetent practitioners." 37/ The impact of the introduction of a new regulatory framework for the financial services industry will be felt in both the domestic and the international market for securities traded in London. For the first time, the trading market in the United Kingdom for Eurobonds and Euroequities will be subject to formal investor protection regulation. It is anticipated that dealers and underwriters of

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36/ The Financial Services Act will be implemented in phases during 1987. It is intended to protect investors in a broad range of financial products. The Act establishes a Securities and Investments Board ("SIB") which is responsible for setting regulatory standards with responsibility for ongoing supervision of market participants delegated to self-regulatory organizations.

37/ "Regulatory System For The New Era," Sir Kenneth Brill, The Stock Exchange A Market Place for Tomorrow (London: Sterling Publications Limited, 1986), pages 119-124.

Eurobonds and Euroequities will become members of a registered or designated investment exchange and a related SRO. 38/ The London Stock Exchange 39/ has applied to the Securities and Investments Board ("SIB") to become the recognized investment exchange for both domestic and international equities traded in London while the Association of International Bond Dealers ("AIBD") has made application with the SIB to be a designated investment exchange for Eurobonds. 40/

The domestic market in the United Kingdom has become more accessible to foreign financial institutions as a result of the liberalizations associated with "Big Bang" and London has long been the center of trading for the Eurobond market. There are, however, some restrictions in underwriting sterling-denominated securities. A United Kingdom owned institution must serve in the capacity of a co-lead manager. A foreign-owned institution

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38/ In the event that a market participant does not wish to become a member of a registered or designated investment exchange, it would be necessary to register directly with the SIB.

39/ Under the Financial Services Act, The London Stock Exchange was formally designated the International Stock Exchange of the United Kingdom and the Republic of Ireland, LTD.

40/ The London Stock Exchange has merged with the International Securities Regulatory Organization ("ISRO") to form the Securities Association which is in the process of applying to the SIB for recognition as an SRO for domestic and international equities and for Eurobonds traded in London. See The Stock Exchange Quarterly (London), Winter 1986, page 8; National Treatment Study 1986 Update, pages 223-227; and "Big Dealers Expected to Fight AIBD Prices Plan," Financial Times (London), April 28, 1987, page 25.

can serve as a co-lead manager of sterling-denominated issues if reciprocal treatment is provided to United Kingdom firms in the home country of the foreign-owned institution. 41/

In Japan, the domestic securities market has become more accessible to foreign issuers and market participants in recent years. Access to the yen sector of the Eurobond market has improved. Euroyen bond issues can now be managed by non-Japanese financial institutions. Prior to December 1984, non-Japanese financial institutions, including U.S. investment bankers, were not permitted to act as a lead manager of Euroyen bond issues, and the yen sector of the Eurobond market was accessible only to foreign public borrowers.

The Japanese Ministry of Finance has taken a number of other steps in recent years to permit greater access to both the yen sector of the Eurobond market and the issuance of foreign bonds in Japan. Historically, both foreign bonds issued in Japan and Euroyen bonds have been subject to regulations placing restrictions on the frequency, size and offering terms as well as limitations on the type of borrower given access to the market.

In 1983, foreign corporate borrowers were placed on an equal footing with supra-national organizations and sovereign borrowers for a place in the new issue queue for yen-denominated foreign bonds ("Samurai bonds") offered in the Japanese capital market.

41/ National Treatment Study 1986 Update, op. cit., page 225.

In addition, the market was opened to some corporate issuers with a double A or single A rating by a Japanese rating agency and to triple A rated corporate issuers with no previous issuance experience in the international capital markets. 42/

In 1984, additional liberalizations were implemented. The required credit rating was lowered from triple A to double A for foreign governments and official agencies borrowing for the first time in the Japanese foreign bond market. In addition, the ceiling on individual bond issues was raised selectively and the waiting period between two offerings by the same borrower was reduced. 43/

Japanese authorities also took steps in 1984 to permit greater access to the yen sector of the Eurobond market. Foreign corporations, for example, were permitted to issue Euroyen bonds under the same criteria established for Samurai bonds. 44/ At the same time, restrictions were eased on the number and size of Eurobond issues. Non-Japanese financial institutions were permitted to become lead managers of Euroyen bond offerings and certificates of deposit

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42/ Prior to this time, only triple A rated companies with prior experience of issuing bonds in the international capital markets could issue Samurai bonds in Japan. See Financial Market Trends, Volume 25 (June 1983), op. cit., page 134.

43/ Financial Market Trends, Volume 29 (October 1984), op. cit., page 78.

44/ Prior to 1984, Euroyen bond issues were limited to foreign public borrowers. "Developments in International Banking and Capital Markets in 1985," Bank of England Quarterly Bulletin (London), March 1986, page 60.

denominated in Euroyen were authorized. Non-residents were exempt from the Japanese withholding tax when investing in Euroyen bonds issued by Japanese corporations. And foreign borrowers were permitted to issue unsecured Euroyen bonds. 45/

In 1985, the financial subsidiaries of foreign corporations not meeting Japanese rating standards were allowed to issue Samurai bonds and yen denominated Eurobonds when guaranteed by the parent company. The overseas subsidiaries of Japanese corporations were granted limited authorization to issue Euroyen bonds. In 1985, the first issuance of a foreign currency-denominated bond was permitted in Japan ("Shogun bond"). 46/ Further modifications to the regulatory framework occurred in 1986 in the yen sector of the Eurobond market. Japanese corporations were permitted to raise capital through the issuance of floating rate and convertible currency bonds. In addition, the waiting period for

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45/ In order to issue Euroyen bonds, the overseas subsidiaries were required to have a sufficient credit rating, parent guarantee, and insure that the proceeds did not flow back to Japan. BIS Annual Report (1986), *op. cit.*, page 105.

46/ The first public offering of a yen-denominated foreign bond was also issued in the U.S. capital market in 1985 by the Asian Development Bank. This issue for 35 billion yen represented the first instance in which a public issue denominated in a foreign national currency was offered in the U.S. capital market. See Asian Development Bank Annual Report (Manila: Asian Development Bank), March 20, 1986, page 66.

bringing proceeds of the offering back to Japan was reduced to 90 days. 47/

In Germany, Deutsche mark ("DM") bond issues must be under the lead management of a German bank. But foreign-owned "German banks" are now authorized to lead manage such issues provided that German banks are able to do so in the home country of the foreign-owned German bank. 48/ And German banks must be the co-manager or lead manager of the syndicate for foreign currency bond issues with DM options and for dual currency bond issues. 49/ In 1985, German authorities eliminated the mandatory queue for DM-denominated bonds. 50/ And DM-denominated floating rate notes

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47/ Prior to April 1, 1986, the waiting period was 180 days. This change did not apply to the issuance of dual currency bonds. Also, foreign companies were no longer required to satisfy a net worth and asset test in order to issue Euroyen bonds but were required to have credit rating of at least single A. Prospects for Financial Markets in 1986, op. cit., page 35; Financial Market Trends, Volume 33 (March 1986), op. cit., page 121; and Volume 34 (June 1986), page 88.

48/ It was reported in the financial press that at least one U.S. securities firm has applied for a banking license in Germany in order to take advantage of the recent capital market liberalizations that would permit it to lead manage Deutsche mark bond issues. See "Merrill Applies for Banking License in West Germany," Financial Times (London), April 24, 1987, page 29.

49/ Financial Market Trends, Volume 33 (March 1986), op. cit., page 118.

50/ Prior to this, a calendar system existed whereby a committee consisting of major German issuing banks had authority to determine the volume and schedule of issues. This was replaced by a system in which lead managers were simply required to notify the Bundesbank each month of plans to issue DM-denominated bonds. See IMF Study of International Capital Markets (December 1986), op. cit., page 34.

and zero-coupon bonds were introduced to the market. 51/

In Switzerland the market for international bond issues denominated in Swiss francs has traditionally been closely supervised. Swiss authorities do not permit the issuance of Swiss franc Eurobonds. Foreign bonds issued in Switzerland must be lead managed by a Swiss bank.

In recent years, Switzerland has liberalized the operation of its foreign bond market somewhat. Foreign institutions operating in Switzerland are now permitted to participate in the issuing syndicate. In 1984, Swiss authorities abolished the timetable established by the National Bank for the public issue of foreign bonds in the Swiss capital market. As of May 1985, foreign bonds publicly offered in Switzerland were no longer subject to a maximum dollar value limitation. 52/

French authorities provided access to the French franc Eurobond market in 1985. But lead managers were expected to be French banks and new issues were subject to an issuing calendar. There is no formal prohibition against foreign firms lead managing French franc denominated Eurobonds. Nevertheless, in 1986 foreign firms

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51/ Prospects for Financial Markets in 1986, op. cit., page 35.

52/ Between December 23, 1983 and May 15, 1985 the maximum amount of each publicly offered foreign bond issued in Switzerland was SF200 million. Prior to December 23, 1983, the maximum amount for each public bond offering by a foreign borrower was SF100 million. See Financial Market Trends, Volume 20 (November 1981), op. cit., page 63; Volume 29 (October 1984) page 82; and Volume 32 (October 1985), page 80.

did not lead manage bonds issued in the French domestic capital market or in the Eurofranc market. 53/

In Italy, foreign borrowers were authorized to issue Eurobonds denominated in lira as of September 1986 with the issue calendar controlled by Italian authorities. In the Netherlands, the securities departments of certain foreign banks were authorized to lead manage domestic or foreign bond issues. 54/

E. International Bond Markets

The gross volume of bonds placed internationally in 1986 totaled a record $225 billion (see Table II-5). This represents a 36 percent increase from the $166 billion issued in 1985 55/ and more than double the amount brought to the market in 1984. In fact, the market has grown at a compound annual rate of 21 percent since 1976. And, with the exception of 1980, record levels of international bond offerings were achieved in each

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53/ See National Treatment Study 1986 Update, *op. cit.*, page 198.

54/ Bank of England Quarterly Review, *op. cit.*, at page 60.

55/ The 1986 increase is due in part to the sharp depreciation of the value of the U.S. dollar relative to other currencies in which international bond issues are denominated. During 1986, U.S. dollar denominated international bonds accounted for about 55 percent of total dollar value of international bond offerings. The OECD estimates that "on a constant-exchange-rate basis," the value of international bond offerings increased by about 26 percent in 1986 (nine months data, at annual rate) compared to 51 percent in 1985. See Financial Market Trends, Volume 35 (November 1986), *op cit.*, page 38.

Table II-5

DOLLAR VALUE OF INTERNATIONAL BOND OFFERINGS: 1965 to 1986
(US $ Billions)

Year	International Bond Issues			Percent of Total		
	Eurobonds	Foreign Bonds	Total	Eurobonds	Foreign Bonds	Total
1965	$ 0.8	$ 2.4	$ 3.2	25.0%	75.0%	100%
1970	3.5	2.4	6.0	59.0	41.0	100
1975	8.7	11.2	20.0	43.8	56.2	100
1976	14.7	18.4	33.1	44.4	55.6	100
1977	18.7	16.3	35.0	53.5	46.5	100
1978	15.0	20.7	35.7	41.9	58.1	100
1979	18.7	20.3	39.0	47.9	52.1	100
1980	20.4	17.9	38.3	53.2	46.8	100
1981	31.3	20.5	51.8	60.4	39.6	100
1982	50.3	25.2	75.5	66.6	33.4	100
1983	50.1	27.0	77.1	65.0	35.0	100
1984	81.7	27.8	109.5	74.6	25.4	100
1985	135.4	31.0	166.5	81.3	18.7	100
1986	$187.0	$38.4	$225.4	83.0%	17.0%	100%

Note: Totals may not add due to rounding.

Source: OECD Financial Statistics Monthly (various issues)

of the past ten years. 56/ At year-end 1986, there were over $700 billion in international bonds outstanding. 57/

The principal market for foreign bonds during the early post-war period was the United States. The European and Japanese capital markets were less accessible to foreign issuers because of exchange controls and other capital market regulations. The Interest Equalization Tax which was implemented in 1963 and continued until 1974, was intended to reduce capital outflows by discouraging foreign issuers from raising capital in the U.S. This tax gave impetus to the development of the Eurobond market as a means of raising capital by issuing U.S. dollar denominated bonds through international syndicates based primarily in London. 58/ By 1965, U.S. corporations or their overseas

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56/ In the first quarter of 1987, $49.0 billion in Eurobonds were issued -- a 12 percent increase over last year's first quarter and more than twice the amount of Eurobonds issued in the first quarter of 1981. See International Capital Markets Review, op. cit., page 1.

57/ See BIS Annual Report (1986), op. cit., page 87. According to BIS estimates, there were $550 billion in international bonds outstanding at year-end 1985. In 1986, $156 billion in net new international bonds were issued (see Table II-1, page II-7).

58/ For a comprehensive discussion of the origins of the Eurobond market, see The Euro-bond Market Function and Structure, Yoon S. Park (New York: Praeger Publications, 1977); and A History of the Eurobond Market -- The First 21 Years, Ian M. Kerr (London: Euromoney Publications, 1984).

affiliates had become the most important group of borrowers in the Eurobond market. 59/

Historically, the Eurobond market has been a source of funding for a wide variety of borrowers (see Table II-6). During the 1974-1983 period, U.S. and foreign private corporations accounted for about half of all funds raised through Eurobond offerings. The balance consisted of funds raised by state enterprises (25 percent), governments (15 percent) and international organizations (10 percent). Private corporations tend to rely less on foreign bond markets. Governments and international organizations have historically been granted preferential access to a number of foreign bond markets. U.S. corporations account for only a small portion of the funds raised through foreign bonds issued in capital markets outside of the United States.

In recent years, U.S. issuers have been the largest borrowers in the international bond markets followed by the Japanese, British and Canadians. In 1986, U.S. issuers tapped the international bond market for a record $43.7 billion or 19 percent of gross bond offerings in international markets. Eurobond issues accounted for 88 percent of the proceeds raised by U.S. issuers in the international bond markets during 1986. Japanese issuers, the second largest participants, raised $34.3 billion in the

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59/ "Euro-Bonds: An Emerging International Capital Market," Federal Reserve Bank of New York Monthly Review (New York, August 1968).

Table II-6

DISTRIBUTION OF INTERNATIONAL BOND ISSUES
BY TYPE OF BORROWER: 1974-1983
(Percent)

Borrower	Eurobonds	Foreign Bonds Outside U.S.
U.S. Companies	15.7%	4.0%
Foreign Corporations	34.6	22.9
State Enterprises	25.3	23.0
Governments	14.9	25.3
International Organizations	9.5	24.8
All Borrowers	100.0%	100.0%

Note: Data not available after 1983.

Source: World Financial Markets, Morgan Guaranty Trust Company of New York (various issues)

international bond market, of which 74 percent consisted of Eurobonds. The bulk of the remainder consisted of foreign bonds issued in the Swiss market.

During the 1970's, the Eurobond and foreign bond markets were about equal in size. But since 1981, the Eurobond market has grown at a compound annual rate of 43 percent. By comparison, the markets for foreign bonds, including Yankee bonds (foreign bonds issued in the U.S.) grew by only 13 percent. 60/ By 1986, Eurobonds accounted for 85 percent of international bond issues compared to 53 percent in 1980. Prior to 1978, Yankee

60/ For a discussion of foreign bonds issued in the U.S. capital markets, see this chapter, Section K.

bonds were, by far, the largest component of the market for foreign bonds. Since 1978 the Swiss market has been the largest and fastest growing sector of the foreign bond market. This is due at least, in part, to the fact that Swiss monetary authorities do not permit Swiss franc denominated Eurobonds.

F. Eurobond Currency Sectors And Foreign Bond Markets

Since the inception of the Eurobond market, U.S. dollar denominated bonds have consistently accounted for the largest share of the market (see Table II-7). The dollar value of U.S. dollar denominated Eurobonds increased from $25.8 billion in 1981 to $117.2 billion in 1986. But the share of the market accounted for by the U.S. dollar sector declined from 82.4 percent of gross proceeds raised in the Eurobond market in 1981 to 62.7 percent in 1986. 61/

Foreign bonds issued in the U.S. accounted for only 15.9 percent of the $38.4 billion in foreign bonds issued in all markets in 1986 (see Table II-8). With the exception of the rapidly growing foreign bond market in Switzerland, most issuers are shifting to the use of Eurobonds rather than foreign bonds.

61/ In the first quarter of 1987, U.S. dollar denominated Eurobonds accounted for only 37 percent of the value of Eurobonds brought to the market as a result of the continued decline in the value of the U.S. dollar in foreign exchange markets. See "1st Quarter International Corporate Financing 1987, Euromarket Issues," *Investment Dealers Digest* (April 6, 1987), page 46.

Table II-7

EUROBOND ISSUES BY CURRENCY OF ISSUE

Billions of U.S. Dollars

ar	U.S. Dollar	Deutsche Mark	Japanese Yen	Pound Sterling	ECUs	All Other	Total
72	$ 4.3	$1.3	$ *	$0.2	$ *	$ 1.1	$ 6.9
73	2.4	1.1	*	1/	*	0.7	4.2
74	2.0	0.6	*	1/	*	0.8	3.4
75	3.4	2.9	1/	*	*	2.4	8.7
76	9.4	2.8	*	*	*	2.5	14.7
77	11.6	5.2	0.1	0.2	*	1.6	18.7
'8	6.8	6.5	1/	0.3	*	1.3	15.0
'9	10.4	5.9	0.2	0.3	*	1.9	18.7
0	13.6	3.5	0.3	1.0	*	2.0	20.4
1	25.8	1.4	0.4	0.5	0.2	3.0	31.3
2	42.2	3.3	0.6	0.8	0.8	2.6	50.3
3	39.2	4.0	0.2	2.2	2.2	2.3	50.1
4	65.3	4.3	1.2	4.0	2.9	4.0	81.7
5	96.5	9.5	6.5	5.8	7.0	10.1	135.4
6	$117.2	$16.9	$18.7	$10.5	$7.0	$16.8	$187.0

Percent of Total

r	U.S. Dollar	Deutsche Mark	Japanese Yen	Pound Sterling	ECUs	All Other	Total
2	62.1%	18.1%	0.0%	2.3%	*%	17.5%	100%
3	57.0	25.6	0.0	0.7	*	16.7	100
4	58.6	18.8	0.0	0.7	*	21.9	100
5	38.9	33.4	0.1	0.0	*	27.6	100
6	63.9	18.9	0.0	0.0	*	17.2	100
7	61.8	27.9	0.6	1.2	*	8.5	100
8	45.2	44.1	0.5	1.9	*	8.3	100
9	55.4	31.5	1.0	1.6	*	10.5	100
0	66.9	16.9	1.5	4.8	*	9.9	100
1	82.3	4.5	1.3	1.7	.5	9.7	100
2	83.9	6.5	1.2	1.7	1.6	5.1	100
3	78.2	8.1	.5	4.3	4.4	4.6	100
4	79.9	5.3	1.5	4.9	3.6	4.8	100
5	71.2	7.0	4.8	4.3	5.2	7.5	100
6	62.7%	9.0%	10.0%	5.6%	3.7%	9.0%	100%

nil or no transactions

Less than $80 million

ce: OECD International Markets Financial Statistics Monthly (various issues)

bonds were, by far, the largest component of the market for foreign bonds. Since 1978 the Swiss market has been the largest and fastest growing sector of the foreign bond market. This is due at least, in part, to the fact that Swiss monetary authorities do not permit Swiss franc denominated Eurobonds.

F. Eurobond Currency Sectors And Foreign Bond Markets

Since the inception of the Eurobond market, U.S. dollar denominated bonds have consistently accounted for the largest share of the market (see Table II-7). The dollar value of U.S. dollar denominated Eurobonds increased from $25.8 billion in 1981 to $117.2 billion in 1986. But the share of the market accounted for by the U.S. dollar sector declined from 82.4 percent of gross proceeds raised in the Eurobond market in 1981 to 62.7 percent in 1986. 61/

Foreign bonds issued in the U.S. accounted for only 15.9 percent of the $38.4 billion in foreign bonds issued in all markets in 1986 (see Table II-8). With the exception of the rapidly growing foreign bond market in Switzerland, most issuers are shifting to the use of Eurobonds rather than foreign bonds.

61/ In the first quarter of 1987, U.S. dollar denominated Eurobonds accounted for only 37 percent of the value of Eurobonds brought to the market as a result of the continued decline in the value of the U.S. dollar in foreign exchange markets. See "1st Quarter International Corporate Financing 1987, Euromarket Issues," *Investment Dealers Digest* (April 6, 1987), page 46.

Table II-7

EUROBOND ISSUES BY CURRENCY OF ISSUE

Billions of U.S. Dollars

ear	U.S. Dollar	Deutsche Mark	Japanese Yen	Pound Sterling	ECUs	All Other	Total
972	$ 4.3	$1.3	$ *	$0.2	$ *	$ 1.1	$ 6.9
973	2.4	1.1	*	1/	*	0.7	4.2
974	2.0	0.6	*	1/	*	0.8	3.4
975	3.4	2.9	1/	*	*	2.4	8.7
976	9.4	2.8	*	*	*	2.5	14.7
977	11.6	5.2	0.1	0.2	*	1.6	18.7
978	6.8	6.5	1/	0.3	*	1.3	15.0
979	10.4	5.9	0.2	0.3	*	1.9	18.7
980	13.6	3.5	0.3	1.0	*	2.0	20.4
981	25.8	1.4	0.4	0.5	0.2	3.0	31.3
982	42.2	3.3	0.6	0.8	0.8	2.6	50.3
983	39.2	4.0	0.2	2.2	2.2	2.3	50.1
984	65.3	4.3	1.2	4.0	2.9	4.0	81.7
985	96.5	9.5	6.5	5.8	7.0	10.1	135.4
986	$117.2	$16.9	$18.7	$10.5	$7.0	$16.8	$187.0

Percent of Total

ear	U.S. Dollar	Deutsche Mark	Japanese Yen	Pound Sterling	ECUs	All Other	Total
72	62.1%	18.1%	0.0%	2.3%	*%	17.5%	100%
73	57.0	25.6	0.0	0.7	*	16.7	100
74	58.6	18.8	0.0	0.7	*	21.9	100
75	38.9	33.4	0.1	0.0	*	27.6	100
76	63.9	18.9	0.0	0.0	*	17.2	100
77	61.8	27.9	0.6	1.2	*	8.5	100
78	45.2	44.1	0.5	1.9	*	8.3	100
79	55.4	31.5	1.0	1.6	*	10.5	100
80	66.9	16.9	1.5	4.8	*	9.9	100
81	82.3	4.5	1.3	1.7	.5	9.7	100
82	83.9	6.5	1.2	1.7	1.6	5.1	100
83	78.2	8.1	.5	4.3	4.4	4.6	100
84	79.9	5.3	1.5	4.9	3.6	4.8	100
85	71.2	7.0	4.8	4.3	5.2	7.5	100
86	62.7%	9.0%	10.0%	5.6%	3.7%	9.0%	100%

= nil or no transactions

Less than $80 million

ource: OECD International Markets Financial Statistics Monthly (various issues)

Table II-8

FOREIGN BOND ISSUES IN SELECTED CAPITAL MARKETS

Billions of U.S. Dollars

Year	United States	Germany	Japan	United Kingdom	Switzer-land	Nether-lands	All Other	Total
1972	$1.6	$0.6	$0.6	$ *	$ 0.9	$ 1/	$0.6	$ 4.3
1973	1.5	0.5	0.3	1/	1.5	*	0.7	4.5
1974	3.6	*	*	*	0.9	1/	0.7	5.2
1975	6.7	0.4	0.1	.1	3.4	0.2	0.3	11.2
1976	10.8	1.2	0.2	*	5.4	0.7	0.1	18.4
1977	7.9	1.4	1.3	*	5.0	0.2	0.5	16.3
1978	6.4	1.4	4.4	*	7.4	0.4	0.7	20.7
1979	4.4	2.7	2.7	*	9.7	0.2	0.6	20.3
1980	2.7	5.0	1.5	0.2	7.5	0.3	0.8	17.9
1981	6.9	1.2	2.7	0.9	8.1	0.4	0.2	20.5
1982	6.0	2.1	3.3	1.1	11.3	0.9	0.4	25.2
1983	4.7	2.6	3.9	0.9	13.5	0.9	0.6	27.0
1984	4.3	2.4	4.9	1.6	13.1	0.9	0.6	27.8
1985	4.7	1.7	6.4	1.0	15.0	1.0	1.2	31.0
1986	$6.1	$ *	$4.8	$0.5	$23.4	$1.8	$2.0	$38.4

Percent of Total

Year	United States	Germany	Japan	United Kingdom	Switzer-land	Nether-lands	All Other	Total
1972	36.7%	13.6%	15.2%	*%	20.3%	0.7%	13.5%	100%
1973	32.9	10.0	6.6	0.2	34.1	*	16.2	100
1974	68.4	*	*	*	18.6	0.8	12.2	100
1975	59.8	3.2	0.6	0.3	30.4	2.0	3.7	100
1976	58.7	6.4	1.2	*	29.2	3.8	0.7	100
1977	48.4	8.7	7.9	*	30.5	1.1	3.4	100
1978	30.7	6.9	21.2	*	35.8	1.7	3.7	100
1979	21.5	13.3	13.2	*	47.9	0.8	3.3	100
1980	15.1	27.6	8.6	1.0	41.7	1.8	4.2	100
1981	33.4	5.8	13.3	4.4	39.6	2.1	1.4	100
1982	23.9	8.4	13.2	4.5	44.9	3.4	1.8	100
1983	17.5	9.7	14.2	3.2	50.0	3.5	2.0	100
1984	15.5	8.7	17.5	5.9	47.2	3.1	2.1	100
1985	15.0	5.6	20.6	3.1	48.2	3.2	4.4	100
1986	15.9%	*%	12.5%	0.8%	60.9%	4.7%	5.2%	100%

* = nil or no transaction

1/ Less than $45 million

Source: OECD International Markets Financial Statistics Monthly (various issues)

Several factors have contributed to the growth in the non-U.S. dollar currency sectors of the Eurobond market. The liberalization of capital market regulations made it easier to issue Eurobonds denominated in currencies which traditionally had been subject to close supervision. The recent trend toward capital market deregulation has also facilitated financial innovations which, in turn, has contributed to the expansion of non-dollar currency sectors. And volatility in foreign exchange markets has created a greater need for currency diversification.

The depreciation in the value of the U.S. dollar relative to other currencies, together with uncertainty concerning future movements in the value of the dollar, contributed to the expansion of the non-dollar currency sectors of the Eurobond market. The U.S. dollar reached its peak in early 1985. Since then, it has declined sharply relative to the Japanese yen and the Deutsche mark -- the second and third largest currency sectors of the Eurobond market (see Chart 1).

The growth in currency swap related borrowing opportunities has also contributed to the expansion of the non-dollar currency sectors. For example, U.S. issuers can issue Eurobonds denominated in a foreign currency and then swap the proceeds of the offering into U.S. dollars. The value of currency swaps related to bonds issued in the international markets is estimated to have amounted to about $38 billion in 1986 compared to $2.3 billion in 1982. During the first nine months of 1986, currency swap-related

Chart 1

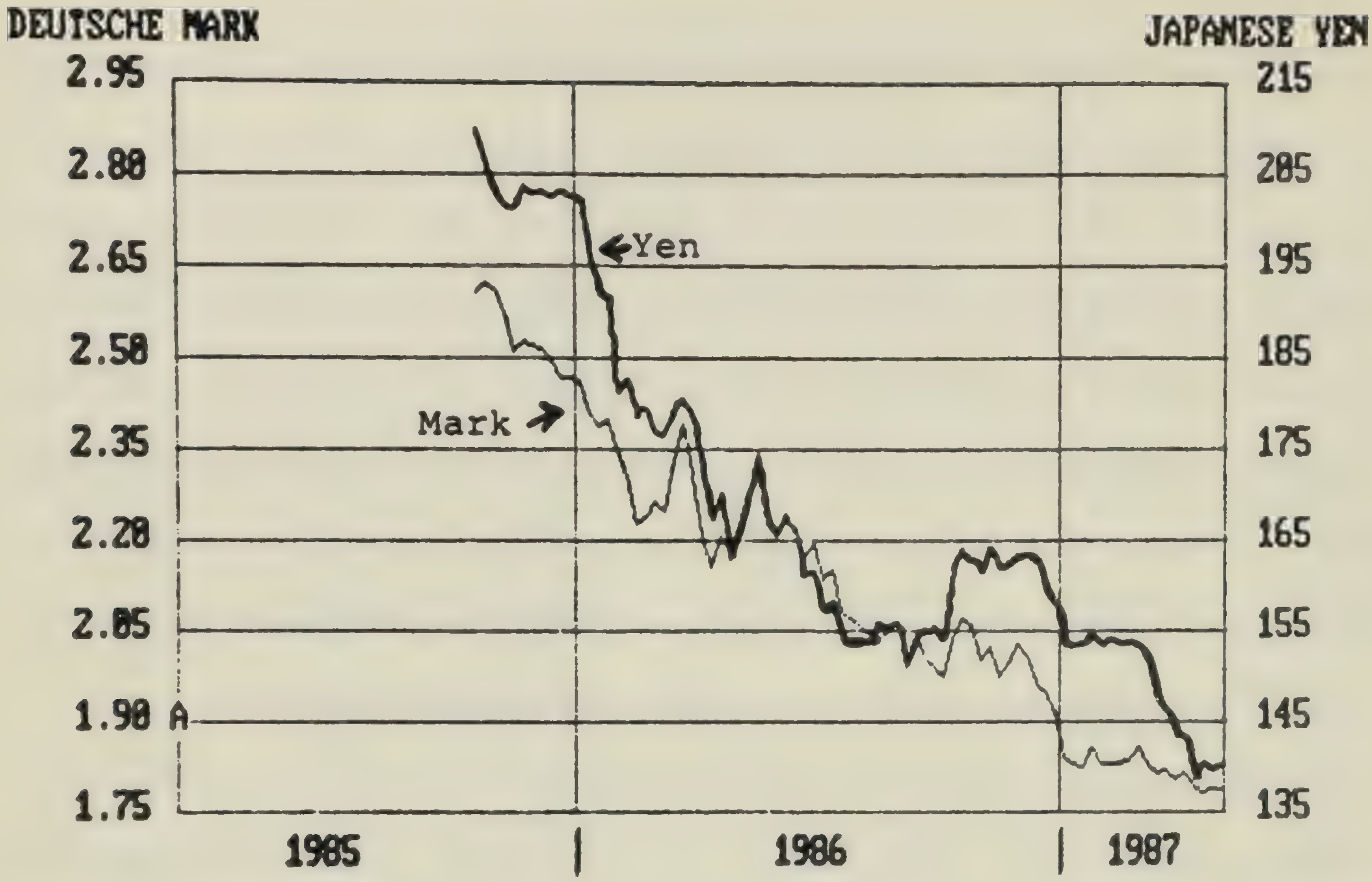
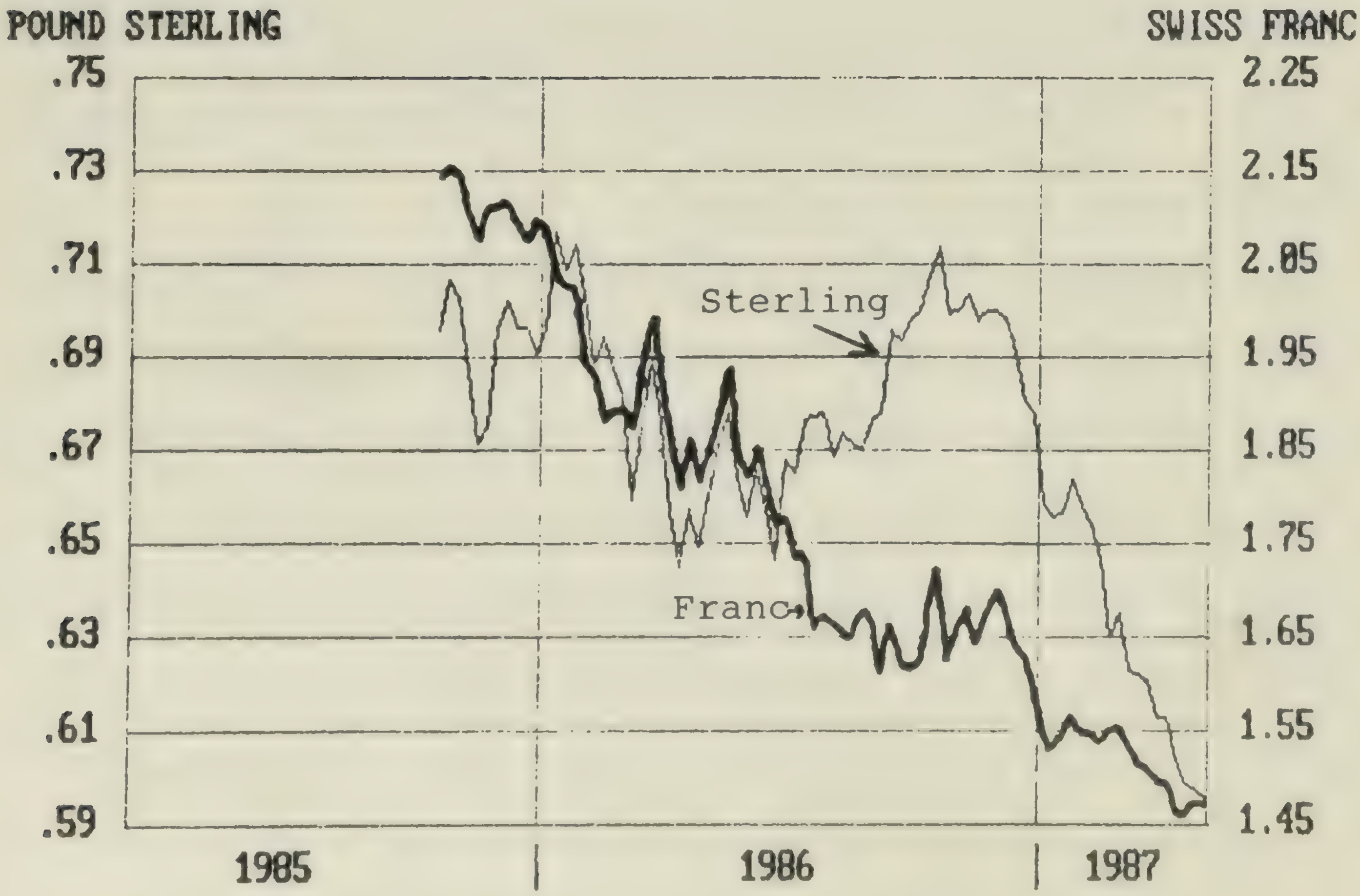


Chart 2



issues accounted for 27 percent of non-dollar bonds issued internationally. 62/ Swaps have facilitated the expansion of less frequently used currency sectors of the Eurobond market and have served as a vehicle to take advantage of arbitrage opportunities created by regulatory barriers. 63/

During the 1981-1986 period, the U.S. dollar segment of the Eurobond market grew at an annual rate of 35 percent while the other currency sectors combined grew by 66 percent. Not since 1978, when Deutsche mark Eurobonds achieved a 44 percent market share, has the lead position of the U.S. dollar sector of the Eurobonds been seriously challenged. While the yen and Deutsche mark have been the fastest growing sectors of the market in recent years, each of these currency sectors accounted for no more than 10% of the value of Eurobonds issued in 1986.

Despite the recent growth of the yen, Deutsche mark and British pound currency sectors of the Eurobond market, U.S. dollar denominated bonds accounted for about two-thirds of the $187 billion in Eurobonds brought to the market in 1986. Although the relative importance of U.S. dollar denominated Eurobonds has fluctuated widely over the 15-year period displayed in Table II-7, it has consistently been the largest currency sector.

62/ Prospects for Financial Markets in 1987, Salomon Brothers, Inc. (December 16, 1986), page 23.

63/ BIS Annual Report (1986), op. cit., pages 104-105.

The strong long-term showing of U.S. dollar denominated Eurobonds reflects the importance of the dollar as an international currency, the relative importance of U.S. corporate issuers in the Eurobond market, and the lack of regulatory restrictions in the dollar sector of the market. Short-term, year-to-year fluctuations in the relative importance of the various Eurobond currency sectors are influenced by interest rate differentials among currency sectors, volatility and expectations regarding future changes in currency values and the imposition and relaxation of regulations in some currency sectors of the Eurobond market.

Part of the recent increase in both the non-dollar currency sectors of the Eurobond market and in foreign bond markets outside of the U.S. is due to the sharp depreciation of the value of the U.S. dollar -- the unit of measure for most international financial statistics, including historical data on international bonds. The effect of changes in the value of the U.S. dollar (relative to other currencies) on the growth rates of international bonds denominated in local currencies is displayed in Table II-9. For example, Deutsche mark-denominated international bond issues increased from DM32.0 billion in 1985 to DM36.9 billion in 1986 or 15.3 percent. Measured in U.S. dollars the value of Deutsche mark-denominated international bond issues increased by 56.3 percent. Likewise, between 1985 and 1986 yen-denominated Eurobonds and foreign bonds offered in Japan increased by 32.7

Table II-9

INTERNATIONAL BOND OFFERINGS
(Valued in Local Currencies)

Years	D Mark	Yen	Swiss Franc
	(Billions)		
1982	DM13.0	Y1,101	SF22.8
1983	16.8	969	28.2
1984	19.3	1,447	30.4
1985	32.0	2,958	35.9
1986	DM36.9	Y3,926	SF42.0
Compound Annual Growth Rates Measured in U.S. Dollars and Local Currencies			
1985-86			
U.S. Dollars	56.3%	87.9%	59.7%
Local Currences	15.3	32.7	17.0
1982-86			
U.S. Dollars	33.4	51.1	20.0
Local Currencies	29.8%	37.4%	16.5%

Source: OECD Financial Market Trends (various issues)

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percent when measured in yen but by 87.9 percent when valued in U.S. dollars. 64/

Japanese issuers and investors have played a much larger role in the international bond markets in recent years. The Euroyen sector, in particular during 1985 and 1986, has been affected by

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64/ Changes in the value of the U.S. dollar relative to other currencies in which international bonds are denominated can have a significant effect on the growth rates of non-dollar currency sectors. The rates of return available to investors in various currency sectors are heavily influenced by the volatility of foreign exchange rates. Quarterly data on the value of the U.S. dollar in relation to nine other currencies are set forth in Appendix Table II-H.

modifications to capital market regulation introduced by the Japanese Ministry of Finance. Yen-denominated Eurobonds increased from about $300 million in 1980 to $6.5 billion in 1985, while foreign bonds issued in Japan rose from $1.5 billion to $6.4 billion. In 1986, yen-denominated Eurobonds expanded to $18.7 billion -- nearly three times the amount issued the previous year. But, at $4.8 billion, foreign bonds issued in Japan declined by 33.4 percent from the record level achieved in 1985. Yen-denominated Eurobonds accounted for ten percent of the value of Eurobonds issued in 1986 compared to less than two percent in all years prior to 1985.

It is estimated that 80 percent of Euroyen issues are swapped into other currencies. U.S. issuers are the largest borrowers in the Euroyen market with about 30 percent market share followed by Japanese issuers at about 10 percent. 65/ In contrast to the Euroyen market, the foreign bond market in Japan has not been used extensively by U.S. issuers. Even in 1985, when U.S. issuers raised a record $345 million through foreign bonds issued in Japan, they accounted for only five percent of the market. International development institutions were the largest borrowers accounting for 35 percent of foreign bonds issued in Japan,

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65/ Financial Market Trends, Volume 35 (November 1986), op. cit., pages 54-55.

followed by Australia (11 percent), and issuers from Asian countries of which China was the largest borrower at $520 million. 66/

During the 1985-86 period, the value of Swiss franc foreign bonds brought to the market increased from $15.0 billion to $23.4 billion -- an increase of 56 percent. But measured in Swiss francs, international bonds issued in Switzerland increased by 17 percent -- from SF35.9 billion in 1985 to SF42.0 billion in 1986. Over this period, the market share of foreign bonds issued in the Swiss market measured in U.S. dollars increased from 48.4 percent of foreign bonds issued in all markets in 1985 to 60.9 percent in 1986.

Part of the increase in the relative importance of the Swiss franc foreign bond market is due to currency realignments. The Swiss franc appreciated by 60 percent against the U.S. dollar over this period (SF2.76 per dollar in the first quarter of 1985 to SF1.66 in the fourth quarter of 1986). Japanese issuers have been the most active participants in the Swiss market and have frequently used the market for currency and interest rate swaps. They also have been particularly active in the issuance of bonds convertible into the shares of Japanese companies. 67/ During

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66/ OECD Financial Statistics Monthly (August 1986), op. cit., page 20.

67/ International Capital Markets Developments and Prospects, (Occasional Paper No. 43), op. cit., page 66; and Financial Market Trends, Volume 35 (November 1986), op. cit., pages 56-57.

the past three years, Japanese issuers accounted for about 40 percent of foreign bonds issued in the Swiss market. American issuers were second at 16 percent.

In 1986, $16.9 billion in Deutsche mark bonds were brought to the market of which 25 percent consisted of borrowings by German issuers. 68/ The second largest borrowers in the Deutsche mark sector were international organizations (10 percent) while U.S. issuers accounted for about five percent. During 1986, Deutsche mark issues constituted the third largest compartment of the international bond market. It was exceeded only by international bonds (Euro and foreign) denominated in U.S. dollars and Japanese yen and by foreign bonds issued in Switzerland. International issues of bonds denominated in pound sterling (Euro- and foreign bonds) achieved a record $11.0 billion in 1986. Eurobonds issued in pound sterling represented less than six percent of total bonds issued internationally.

68/ In 1986, all Deutsche mark international bond issues were classified as Eurobonds. OECD statistics no longer make a distinction between Deutsche mark Eurobonds and foreign bonds issued in Germany. All Deutsche mark international bonds must be lead managed by a German bank or by the German subsidiary of a bank operating in Germany. And Deutsche mark Eurobonds must be listed on a German stock exchange and are therefore eligible for immediate secondary market trading in Germany.

G. Secondary Market In Eurobonds

The secondary market trading in Eurobonds has kept pace with the rapid growth in the primary market. 69/ This in turn has facilitated liquidity and marketability of Eurobond issues. Secondary trading in Eurobonds increased from $240 billion in 1980 to $2.2 trillion in 1985 (see Table II-10). Between 1985 and 1986, trading volume in Eurobonds increased by 62 percent. In 1986 secondary market trading totaled a record $3.6 trillion. Since 1980, the primary or new issues market for Eurobonds has grown at an annual rate of 45 percent while secondary market trading has expanded by 57 percent. The portion of dollar volume cleared by each of the two principal clearing agencies for the Eurobond market (Euroclear and Cedel) has remained relatively constant over this period. Typically, Eurobond issues are listed on the London Stock Exchange or other European exchanges but secondary market trading is conducted primarily over-the-counter.

H. The International Equity Market

The recent growth in the volume of new issues has increased the role and significance of the international equity market.

69/ Secondary market trading in Eurobonds occurs primarily in the over-the-counter market, but some trading does take place in exchange markets. The secondary market trading data presented in Table II-10 includes all over-the-counter activity which is cleared exclusively by Cedel and Euroclear as well as exchange trading, to the extent it is cleared by Cedel or Euroclear.

Table II-10

SECONDARY MARKET TRADING IN EUROBONDS
(Volume in US $ Billions)

Year	Total Volume	Percent of Total by Clearing Agency: Cedel	Euroclear
1978	$ 115.8	33.9%	66.1%
1979	155.9	35.1	64.9
1980	240.0	33.1	66.9
1981	413.8	38.0	62.0
1982	846.3	38.8	61.2
1983	900.6	42.6	57.4
1984	1,590.2	36.6	63.4
1985	2,208.0	34.4	65.6
1986	$3,570.1	34.0%	66.0%

Source: The Association of International Bond Dealers

The international equity market encompasses the underwriting and distribution of equity securities to investors in one or several markets outside the issuer's home market by a syndicate of international securities firms and banks. The market for international equities is similar to the international bond market. International equity securities include common and preferred stocks (generally referred to as Euroequities). But equity-related bond issues (convertibles and bonds with equity warrants) have been an important vehicle for raising capital in international markets since the early 1980's. A two-fold increase in the issuance of equity-related bonds in 1986 coincided with the surge in stock prices on the world's major stock exchanges.

As indicated in Table II-11, Euroequity offerings of common and preferred stocks have increased at a rapid pace. The $11.8

Table II-11

VALUE OF INTERNATIONAL EQUITY AND EQUITY-RELATED BOND OFFERINGS
(US $ Billions)

Year	Common And Preferred Stocks	Equity-Related Bonds 1/	Total
1983	0.2	8.0	8.2
1984	1.2	10.9	12.1
1985	3.5	11.5	15.0
1986	11.8	22.3	34.1

1/ Convertible bonds and bonds with warrants.

Sources: Euromoney Bondware, Euromoney Publications
Financial Market Trends, OECD

billion in Euroequities brought to the market in 1986 include both international issues in the Euromarket as well as the foreign tranches of domestic issues that are directed to particular foreign equity markets. 70/

As the Euroequity market develops, it may acquire more of the characteristics of the international bond market, *e.g.*, a generally recognized distinction between issues that are simultaneously offered internationally in multiple markets (the equity equivalent of the eurobond) and those issues directed to a particular foreign equity market (the equity equivalent of a foreign bond). The present state of the international equity market is

70/ *Raising Equity in the Euromarket*, Credit Swiss First Boston, London, 1986, page 11.

not unlike that of the international bond market in the mid-1960's, when the distinction between Eurobonds and foreign bonds was less clear than it is today. 71/

Although issuers have increasingly used the international equity markets, some of the objectives of these offerings may not be realized if the shares flow back to the issuer's domestic market. Since the domestic or home market normally is the primary market for any given security, the home market normally attracts shares that overseas investors may want to trade. The return of a large amount of shares to the domestic market, however, may exert downward pressure on the issuer's stock price and can frustrate the efforts of corporations to broaden the shareholder base. Market participants, therefore, generally believe that flowback creates a disincentive to the development of an international equity market. 72/

The lead managers in the Euroequity market are frequently those firms that are also prominent in the Eurobond market. During 1986, the top five lead managers in the Euroequity market accounted for 19.2% of the dollar volume and 38.5% of the total number of issues. Of these five firms, two were also among the top five managers in the Eurobond market.

71/ European Capital Markets, I. Scott, Office of the Comptroller of the Currency (1968), pages 201-217.

72/ "Cutting Off the Flowback Menace," Euromoney, op. cit., page 48 and "Euroequities Are Here to Stay," Euromoney, op. cit., page 70.

At this point, despite tremendous growth, the Euroequity market is still small compared to the Eurobond market (see Table II-12). German, Italian, and British issuers are heavy users of the Euroequity market. As a group, issuers from these three countries raised approximately $8.9 billion worth of capital in the Euroequity market during the four year period ending in 1986. The amount of Euroequity capital raised to date by U.S. issuers ($1.9 billion) is small in relation to the role played by U.S. issuers in the Eurobond market. Nevertheless, U.S. issuers led all countries with 38 issues during the 1983-1986 period. It appears that U.S. issuers have generally satisfied their equity capital needs in the domestic market but have occasionally directed a tranche of their offerings overseas in an effort to increase their international exposure.

The amount of capital raised in the Euroequity market by U.S. issuers may be affected somewhat by the regulatory framework in the U.S. In 1964, the Commission established a policy that it would not initiate action against an unregistered issue so long as the offering occurred overseas and was not sold to U.S. citizens. The accepted procedure for assuring that the issue "came to rest abroad" has been to include clauses in the underwriting and selling agreements not to sell the issue in the U.S. as well as sales restrictions in the lock-up period during which the security may not be sold to U.S. investors.

Table II-12

THE EUROEQUITY AND EUROBOND MARKETS
(1983 - 1986 Combined)

Issuers Country of Origin	The Euroequity Market: Dollar Value of Offering	Number of Issues
Germany	$ 3.8	7
United Kingdom	2.6	18
Italy	2.5	11
Switzerland	2.0	21
United States	1.9	38
France	1.8	20
Netherlands	0.6	7
Sweden	0.5	3
Canada	0.3	13
Japan	0.2	7
All Other	0.5	17
Total	$16.7	162

Issuers Country of Origin	Euroequity Versus Eurobond Markets: Euroequity	Eurobond	Euroequity As % of Total
Germany	$ 3.8	$ 17.4	17.9%
United Kingdom	2.6	39.8	6.1
Italy	2.5	14.6	14.6
Switzerland	2.0	4.2	32.3
United States	1.9	102.6	1.8
France	1.8	35.9	4.8
Netherlands	0.6	6.0	9.1
Sweden	0.5	16.7	2.9
Canada	0.3	29.0	1.0
Japan	0.2	58.2	0.3
All Other	0.5	129.8	0.4
Total	$16.7	$454.2	3.5%

Note: The volume data is in billions of U.S. dollars.

Source: OECD International Financial Statistics Monthly (various issues) and Euromoney Bondware, Euromoney Publications, London

These restrictions may preclude U.S. investors from participating in the issue. 73/

The use of the Euroquity market by U.S. issuers did, however, increase substantially during 1986. U.S. issuers raised $1.7 billion in 1986 compared with $200 million from 1983 to 1985. With the exception of the U.S. and the United Kingdom, it appears that issuers in the Euroequity market come primarily from European countries whose home equity markets are relatively small. 74/

The Euroequity market has not yet developed the automated clearance and settlement facilities which are available for Eurobonds. Trading in Euroequities may not achieve its full potential without enhancements in systems used to clear and settle equity transactions. The lack of automated systems for the clearance and settlement of international transactions has tended to limit the flow of equity capital across national borders. 75/ The physical delivery of securities can be a costly and cumbersome procedure.

73/ For further discussion, see Chapter III of this study. Also see the Roundtable on the Internationalizaton of the Securities Markets, Securities and Exchange Commission, February 17, 1987, transcript pages 97-120.

74/ "Raising Money with Global Equities," Dun's Business Month (February 1987), pages 50-52.

75/ See discussion of problems in clearance and settlement in international equity transactions in Chapter V.

One important aspect of the Euroequity market is the ability it provides issuers to offer equity with varying features. For example, one of the latest developments in the Euroequity market is the increase in corporate issues of non-voting stock whereby corporations can raise new capital without a dilution of control. Scandinavian corporations, for example, have also used non-voting issues to avoid domestic restrictions on foreign stock ownership. 76/

The demand for international equities comes primarily from investors in Switzerland, the United Kingdom, Germany and Japan. The profile of international equity investors, however, differs among each of these market centers. In Switzerland, international equity investors are generally individual investors from throughout the world whose funds are managed by the major Swiss banks. Similarly, international equity investors in Germany are individual investors whose funds are managed on a discretionary basis by the universal banks. In the United Kingdom and Japan, international equity investors are primarily institutions such as insurance companies and pension funds.

New issues of equity-related international bonds -- convertibles and bonds with warrants -- grew from $8.0 billion in 1983 to $22.3 billion in 1986 (see Table II-13). New issue volume

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76/ "Selling Equities to the World"' Euromoney (London), November 1986, page 5. "The International Equity Market, CSFB," Euromoney Special Sponsored Supplement (London), November 1986.

Table II-13

ISSUANCE OF EQUITY-RELATED BONDS
IN INTERNATIONAL MARKETS
(US $ Billions)

Issuers	1983	1984	1985	1986
Japan	$ 4.9	$ 7.6	$ 6.8	$11.8
United States	1.0	1.9	2.2	2.9
United Kingdom	0.3	0.3	0.7	1.3
Germany	0.7	0.3	1.0	1.7
Switzerland	0.6	0.2	0.2	0.7
Other OECD	0.5	0.6	0.6	3.9
Total	$ 8.0	$10.9	$11.5	$22.3
Breakdown By Currency Sector		(Percent) 1/		
U.S. Dollar	48.8%	50.5%	46.1%	52.5%
Swiss Franc	45.0	38.5	35.7	30.0
German Mark	5.0	8.3	10.4	12.6
Other	1.3	2.8	7.8	4.9
Total	100.0%	100.0%	100.0%	100.0%

1/ Data may not sum due to rounding.

Source: OECD Financial Statistics Monthly

has continued to grow in early 1987. During the first quarter of this year new issues of equity-related bonds equalled $5.1 billion, an 11 percent increase from the $4.2 billion raised in the first quarter of 1986 and an 89 percent increase over 1985's $2.7 billion. 77/

77/ *Financial Market Trends*, Volume 37 (May 1987), *op. cit.*, page 99.

Japanese corporations have been the largest issuers of equity-related bonds. Their offerings grew from $4.9 billion in 1983 to $11.8 billion in 1986. Japanese corporations accounted for more than half of the proceeds raised through the flotation of equity-related bonds in international markets in each of the last four years. Japanese corporations have been particularly active in the Swiss market where they are the largest issuers of convertible bonds. U.S. corporations -- second to the Japanese in the issuance of equity-related bonds in international markets -- raised $2.9 billion in 1986.

Bonds with warrants permit investors to purchase equity while still holding the issuer's bonds. An attraction for investors is the possibility of a capital gain in the event that the share price exceeds the exercise price of the warrant. For issuers, warrants offer a high degree of flexibility and may also be less likely to exert downward pressure on a company's stock price in comparison with a straight equity issue.

Convertible bonds, a hybrid security that has some of the attributes of an equity security, allows investors to convert the bond into common stock at a specific price during a specified period. They provide investors with a fixed income stream and the potential to realize a capital gain if the market price exceeds the conversion price. The issuance of convertible bonds and bonds with warrants in international markets has been facilitated by the rapid appreciation of stock prices in the world's major securities markets.

The development and growth of the international equity market stems from issuer demands for greater financial flexibility and capital raising alternatives. This market offers corporations a number of potential benefits. An international equity offering may broaden the issuer's shareholder base to include foreign investors and may increase public awareness of the firm's products and services. An increase in the shareholder base and public awareness may enhance future capital raising efforts.

If the issuer is large relative to the capitalization of its domestic market, the international equity market can also provide an additional source of liquidity to supplement the firm's domestic market for equity shares. Additionally, the current practice in many domestic markets is to issue equity at a discount from market price because the issue is directed to existing shareholders with preemption rights. In the international equity market, however, new issues are generally directed to new investors and are usually priced at the prevailing market, thereby resulting in a lower cost of capital to the issuer. 78/

In addition to issuer demand for new capital raising vehicles, the increase in stock prices in most major stock markets around the world has made equity investments attractive to

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78/ "The Looming Battle in International Equities," Institutional Investor (October 1986), page 320 and Raising Equity in the Euromarket, op. cit., page 3.

institutional investors. 79/ In many countries institutional investors, particularly private pension funds, are growing at a rapid pace. The easing of foreign exchange restrictions and investment controls and the capital market liberalizations in a number of countries have facilitated the purchase of foreign equities by institutional investors.

I. Foreign Stock Listings and International Stock Trading

Listing on a foreign exchange may broaden an issuer's shareholder base and, in some markets, it is necessary in order for domestic institutions to purchase the company's shares. For example, in France local insurance companies may be prohibited from purchasing shares that are not listed on a French bourse. 80/ With respect to certain markets, changes in accounting standards and disclosure requirements have made foreign listings more attractive. This apparently has been a factor in increasing the interest of foreign listings on the Tokyo Stock Exchange. 81/

U.S. exchanges have also undertaken intitiatives to increase the number of foreign listed companies. The American and New York Stock Exchanges in June 1987 received approval from the

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79/ In addition to Charts 3 and 4, Appendix Table II-E shows trends in stock prices for major foreign stock markets.

80/ "Selling Equities to the World", Euromoney, op. cit., page 45.

81/ Ibid, at page 39.

Chart 3

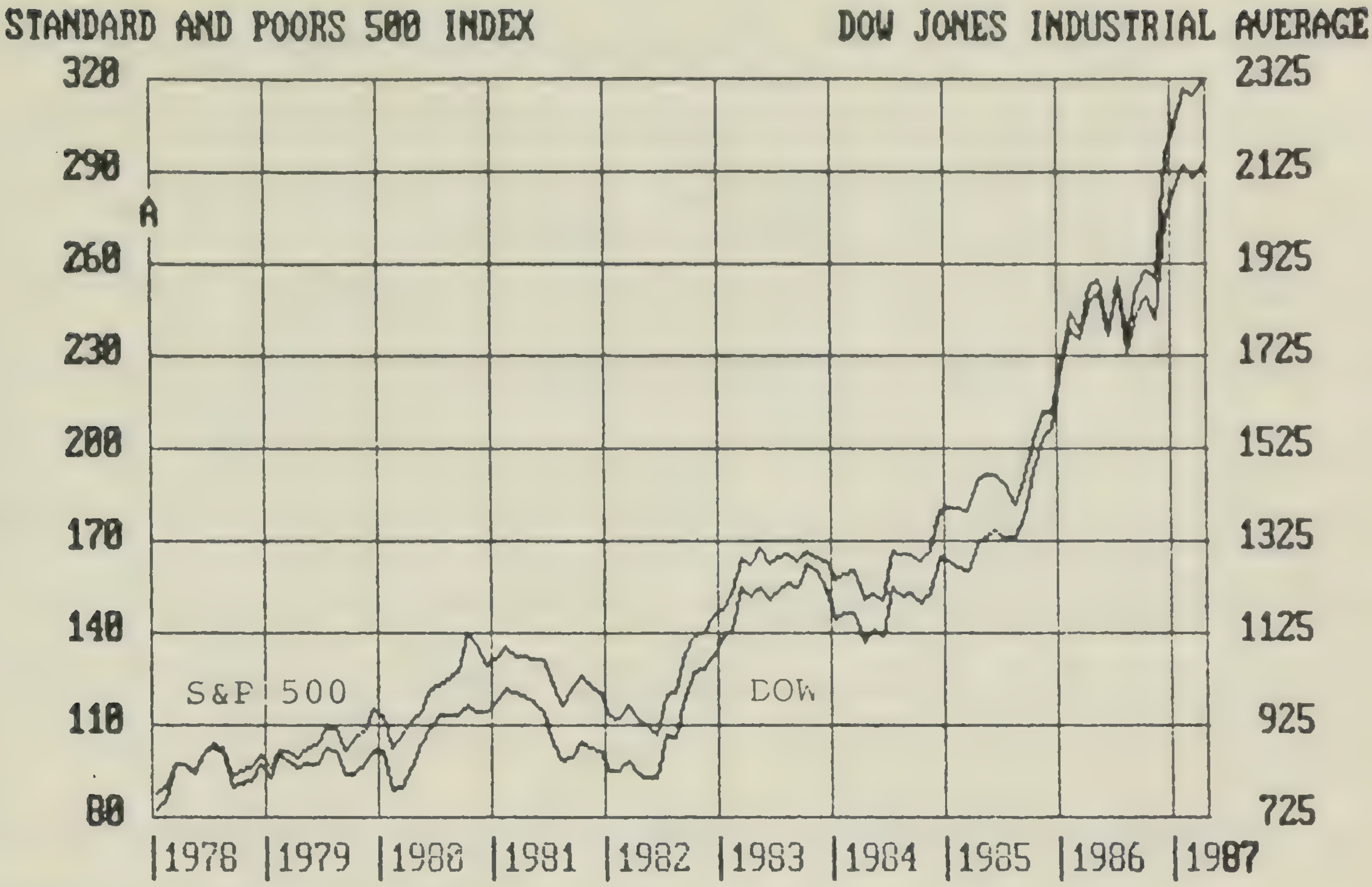
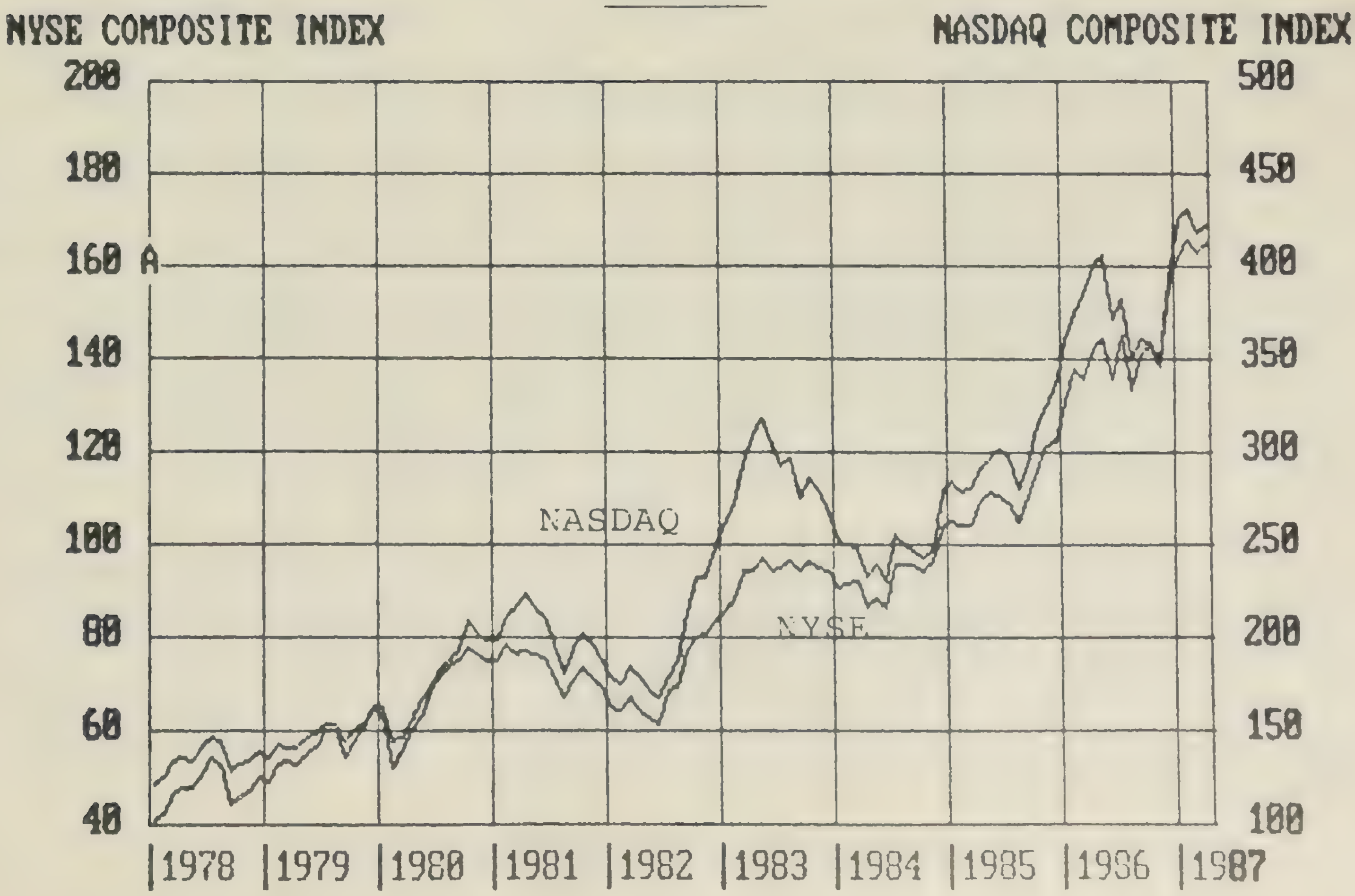


Chart 4



Commission to revise their listing standards. Some foreign corporations apparently had been reluctant to list on U.S. exchanges due to differences in listing standards in the U.S. and their home country. Now certain listing standards may be waived by the American and New York Stock Exchanges if those standards conflict with the laws and practices found in the home market of a foreign corporation. The rule revisions afford U.S. exchanges a better opportunity to compete on an international basis and may provide U.S. investors with greater access to foreign securities. 82/

As of December 1986, 512 foreign corporations had their securities listed on the London Stock Exchange. At the same time 59 foreign companies were listed on the New York Stock Exchange ("NYSE"), approximately one-third of which are Canadian corporations. 83/ At the Tokyo Stock Exchange, 52 foreign firms were listed at year-end 1986 compared to only 21 firms at year-end

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82/ Securities Exchange Act Release No. 34-24634, June 23, 1987. The American and New York Stock Exchanges identified the following areas in which an exemption or waiver might be provided: quarterly reporting of interim earnings, composition and election of the Board of Directors, voting rights and quorum requirements for shareholder meetings.

83/ Of these 59 companies, 22 were traded in the form of American Depository Receipts. For a discussion of American Depository Receipts issued and traded in U.S. markets, see this chapter, Section K. On NASDAQ the number of foreign securities equalled 270 at year-end 1986, a slight increase from 266 in 1985. Of these 270 issues, 92 were traded through the use of American Depository Receipts.

1985. It has been estimated that, on the Tokyo Stock Exchange alone, the number of foreign listed corporations may increase to several hundred within the next five years. 84/

Even some smaller U.S. firms are tapping foreign markets for capital. At least fourteen U.S companies have recently floated their initial public offerings in England and subsequently registered their issues on the London Stock Exchange's Unlisted Securities Market (USM). The British financial press opined that these firms raised capital more cheaply than they could have in the U.S. 85/ Two other advantages were cited for U.S. companies going public in the United Kingdom: corporations can maintain tighter control by issuing fewer shares to public investors; and U.S. companies may use profit forecasts in their British prospectuses. Issuers cannot use their own forecasts in U.S. prospectuses.

Table II-14 shows the extent of foreign stock listings on fourteen of the world's major stock exchanges at year-end 1986. With the exception of Milan, each of the exchanges had at least one non-domestic listing. The London Stock Exchange has the greatest number of U.S. companies listed on an exchange outside of the U.S. and the highest number of foreign listings of any

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84/ "Selling Equities to the World", Euromoney, op.cit., page 40.

85/ "Low Costs Attract," Financial Times (London), January 20, 1987.

Table II-14

DOMESTIC AND FOREIGN LISTED COMPANIES
ON MAJOR STOCK EXCHANGES
(Year-End)

Exchange	Domestic Listings 1985	Domestic Listings 1986	Foreign Listings 1985	Foreign Listings 1986	Total Listings 1985	Total Listings 1986
American	731	747	51	49	783	796
Amsterdam	232	267	242	242	474	509
Australia 1/	1,069	1,162	26	31	1,095	1,193
Brussels	192	191	144	140	336	331
Copenhagen	243	274	6	7	249	281
Germany 1/	451	492	177	181	628	673
London	2,116	2,101	500	512	2,616	2,613
Luxembourg	N/A	253	N/A	168	N/A	421
Milan	147	184	0	0	147	184
New York	1,487	1,516	54	59	1,541	1,575
Paris	489	874	189	226	687	1,100
Singapore	122	122	194	195	316	317
Tokyo	1,476	1,499	21	52	1,497	1,551
Toronto	912	1,034	54	51	966	1,085
Zurich	131	145	184	194	315	339

1/ Reflects data for the Association of Australian and German stock exchanges which include all exchanges in their respective countries.

N.A. - Not available

Source: The London Stock Exchange Quarterly, The London Stock Exchange (various issues)

market. U.S. equity listings on the London Stock Exchange have increased from 73 in 1975 to 199 in 1986. 86/ For the three Benelux countries, 44 percent of the listed corporations are foreign companies, while the comparable figure for the Zurich Stock Exchange is 59 percent.

Trading of foreign shares has increased on many exchanges. On the London Stock Exchange, for example, trading activity in foreign equities has averaged approximately $507 million per day since Big-Bang. Prior to October 27, 1986, this figure may have been as low as $24 million per day. 87/ At the Tokyo Stock Exchange, between 1973 and 1984, annual trading in foreign equities averaged less than two million shares. In 1985, annual volume in foreign equities increased to 131 million, while trading during the first six months of 1986 equalled 185 million shares. 88/

Trading in foreign equity issues has also increased on the NYSE, from 804 million shares in 1984 to 1.2 billion shares in 1986. As a percent of total NYSE share volume, however, the

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86/ London Stock Exchange Quarterly, The London Stock Exchange (various issues).

87/ "Foreign Equities Make up Quarter of London Trades," Wall Street Journal, March 10, 1987, page 54. Due to the reporting standards that existed prior to October 27, 1986 the volume of foreign equities in London may have been greatly understated prior to Big-Bang.

88/ "The Nikko Prospectus on International Equities", Euromoney Supplement (November 1986), page 3.

amount attributable to foreign issues remained fairly constant during this period at approximately 3.5 percent.

These recent developments -- the increase in multinational stock listings and domestic trading of foreign equities -- have fostered interest in the development of a 24-hour global stock market. 89/ Both U.S. and foreign securities firms are responding to this trend. Many now have the ability to trade at any time of the day by having offices in New York, London, Tokyo and in other major financial centers.

In a global 24-hour trading environment, a firm's investment position may be adjusted on a continuous basis because the moment the market closes in one geographic location or time zone it opens in another. Twenty-four hour trading in an international market indicates a high level of market maturity. Very few markets have reached this level of development. The most international of markets today, by this measure, is the foreign currency market. Turnover in that market approaches $200 billion a day. 90/ Likewise, some commodities are traded in a global 24-hour trading

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89/ As early as 1971, SEC Commissioner James J. Needham recognized the possibilities of developing a global 24-hour market in equity securities. See "Restructuring the Securities Industry," Remarks of James J. Needham, Commissioner, U.S. Securities and Exchange Commission, May 17, 1971. For a full discussion of global trading, see Chapter V.

90/ "What is Happening and Why," Richard A. Debs, Remarks presented at the Conference on the Globalization of Financial Markets, Egham, England, October 20, 1986.

environment, e.g., gold and oil. Secondary market trading in U.S. Treasury securities has recently emerged as the latest example of a fully developed international market where trading can be conducted on a 24-hour basis. In fact, the futures contracts on U.S. Treasury bonds are the most actively traded in the world with daily volume of roughly $25 billion. 91/

Many professional traders believe that the Eurobond market will be next to develop to the level of a 24-hour worldwide trading market. This market has not reached that status; the reason may be because of restraints that inhibit transnational flows. An example is the constraint placed by U.S. law concerning the purchase of new Eurobond issues by U.S. citizens.

Although a secondary trading market in equities has the potential to emerge into a global market, at present it appears to be among the least developed global secondary markets when compared to the range of financial instruments that are of global investor interest. Today, investors are purchasing foreign equities at record levels but they are doing so primarily in the home market for the security. But, there is an emerging Euroequity market where the simultaneous issuance of new securities in more than one country is now commonplace. This is a development that could lead to a global trading market in equity securities.

91/ Wall Street Journal, February 10, 1987, page 52.

Transnational trading linkages is another development that could lead to global 24-hour trading in equities. Over the last three years, there have been trading linkages involving three U.S. and two Canadian exchanges. 92/ To date, however, trading through means of U.S.-Canadian linkages has been limited. In 1986, the NASD and the London Stock Exchange began a transatlantic exchange of price quotations on about 600 issuers. The NASD is also planning to begin the exchange of quotations with the Stock Exchange of Singapore.

J. Internationalization of Portfolio Investment Flows

The recent surge in international portfolio investment reflects several important factors (see Table II-15). Among the most important are the increased interdependence of the world economies, regulatory liberalization in a number of important capital markets, the growth in institutional investors in the world's major industrialized countries, and the maturation of of securities markets outside the U.S.

92/ The first linkage was established in 1984 between the Boston and Montreal Stock Exchanges. A second linkage between the American Stock Exchange ("ASE") and Toronto Stock Exchange commenced in 1985. The third linkage was initiated in early 1986 between the Toronto and Midwest Stock Exchanges. For a more complete discussion of the linkages between U.S. and foreign securities markets, see Chapter V. Also see Securities Exchange Act Release No. 21449 (November 1, 1984), 49 F.R. 44575; Securities Exchange Act Release No. 22442 (September 27, 1985), 50 FR 39201; and Securities Exchange Act Release No. 23075 (March 28, 1986), 51 FR 11854.

Table II-15

INTERNATIONAL TRANSACTIONS BY U.S.
AND FOREIGN INVESTORS COMBINED
(US $ Billions)

Year	Stocks	Bonds	Total
1975	$ 29.3	$ 37.0	$ 66.3
1980	93.1	158.1	251.2
1981	94.4	192.0	286.4
1982	95.6	277.5	373.1
1983	164.4	376.9	541.3
1984	153.3	632.9	786.2
1985	204.7	1,292.6	1,497.3
1986	$379.6	$2,613.5	$2,993.1

Note: Data includes both foreign activity (purchases and sales) in U.S. securities and U.S. activity (purchases and sales) in foreign securities.

Source: Treasury Bulletin (various issues)

There has been a trend in Japan and in other countries toward a regulatory framework which facilitates the internationalization of portfolio investments. Japan has liberalized its regulation of cross-border investments in securities by allowing certain financial institutions, such as credit associations and agricultural corporations, to purchase foreign securities. In March 1986, the limit on foreign securities purchases by Japanese life insurance companies was raised from 20 percent to 40 percent of the monthly growth in assets. Similarly, the limit on foreign securities holdings was raised from 10 percent to 25 percent of total assets for trust bank pension funds. 93/ In April 1987,

93/ Financial Market Trends, Volume 34 (June 1986), op. cit.

Japanese financial institutions were authorized to trade in U.S. and other overseas financial futures and options markets. This will enable Japanese institutions to hedge their positions in securities that are denominated in U.S. dollars and other foreign currencies. 94/ These initiatives contributed to the six-fold increase in cross-border transactions involving Japanese securities between 1980 and 1985. 95/

U.S. investors also have increased their purchases of foreign stocks since the elimination of the interest equalization tax. In 1975 U.S. investors bought $1.7 billion in foreign stocks (see Table II-16). 96/ By 1986 U.S. purchases of foreign stocks totaled a record $51.7 billion. In a similar dramatic fashion, U.S. investors have increased their purchases of foreign debt securities from $8.7 billion in 1975 to $169.8 billion in 1986. Though U.S. investors sell their holdings of foreign

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94/ "Japan Authorizes Trading of Futures On Foreign Markets", The Asian Wall Street Journal Weekly, April 27, 1987.

95/ During 1980 foreign purchases and sales of Japanese securities (stocks and bonds) equalled Y10.5 trillion. During 1985 this figure increased to Y68.8 trillion. 1986 Fact Book, Tokyo Stock Exchange.

96/ The data presented on portfolio investment flows were obtained from various issues of the Treasury Bulletin prepared by the U.S. Department of the Treasury. These data include transactions in U.S. and foreign securities where a U.S. resident is on one side of the trade and a foreign resident is on the contra side of the trade. The data do not include transactions between two foreign residents in a U.S. security or transactions between two U.S. residents in a foreign security. (See International Capital Flows, Department of the Treasury).

Table II-16

INTERNATIONAL TRANSACTIONS IN U.S. AND FOREIGN CORPORATE STOCKS AND DEBT SECURITIES
(U.S. $ Millions)

Corporate Stocks

	Foreign Activity in U.S. Stocks			U.S. Activity in Foreign Stocks		
Year	Purchases	Sales	Net Capital Flow	Purchases	Sales	Net Capital Flow
1975	15,355	10,678	4,677	1,730	1,542	-188
1980	40,298	34,870	5,428	10,044	7,897	-2,147
1981	40,686	34,856	5,830	9,586	9,339	-247
1982	41,881	37,981	3,900	8,504	7,163	-1,341
1983	69,770	64,360	5,410	17,046	13,281	-3,765
1984	59,834	62,814	-2,980	15,917	14,816	-1,101
1985	81,995	77,054	4,941	24,803	20,861	-3,942
1986	148,134	129,436	18,698	51,744	50,292	-1,452

All Debt Securities 1/

	Foreign Activity in U.S. Debt Securities			U.S. Activity in Foreign Debt Securities		
Year	Purchases	Sales	Net Capital Flow	Purchases	Sales	Net Capital Flow
1975	14,306	11,545	2,761	8,720	2,383	-6,337
1980	66,595	56,262	10,333	18,090	17,090	-1,000
1981	85,763	65,677	20,086	23,013	17,553	-5,460
1982	117,632	98,863	18,769	33,809	27,167	-6,642
1983	153,680	147,351	6,329	39,572	36,333	-3,239
1984	275,634	241,237	34,397	59,948	56,017	-3,931
1985	585,174	541,042	44,132	85,214	81,216	-3,998
1986	1,176,027	1,100,951	75,076	169,798	166,700	-3,098

1/ Data includes both corporate and governmental debt issues.

Source: U.S. Treasury Bulletin (various issues)

stocks and bonds in adjusting their portfolios, the net capital flow from U.S. transactions in foreign securities has been outbound in every year since 1975. In 1975 U.S. investors purchased $6.3 billion more in foreign securities than they sold. In 1986 net purchases of foreign securities by U.S. investors amounted to $4.5 billion.

Foreign investors' purchases of U.S. stocks and bonds has mirrored the growth of U.S. corporations' presence in overseas markets. Foreigners purchased $15.4 billion of U.S. stocks and $14.3 billion of U.S. debt securities in 1975. In 1986 foreign investors' purchases had increased to $148.1 billion of U.S. stocks and $1.2 trillion of U.S. debt instruments. The net capital flow from their purchases and sales of all U.S. securities has been inbound to the U.S. every year since 1975, increasing from $7.4 billion in 1975 to $93.7 billion in 1986.

Foreign activity in U.S. equity and debt securities reached record highs in 1986. Nevertheless, foreign activity in U.S. debt securities (primarily U.S. Treasury issues) is substantially greater than in U.S. equities. During 1986, 89 percent of the foreign activity in U.S. securities was attributable to transactions in debt securities. The most active foreign participants in the secondary market for U.S. debt securities are investors from Japan and the United Kingdom. Investors from these two countries accounted for 50 percent of the total foreign activity in U.S. debt securities during 1986.

These data, moreover, may underestimate the activity of Japanese investors in U.S. debt markets. This is partly because the recent worldwide expansion of Japanese securities firms, banks, and insurance companies makes it difficult to identify purchases by Japanese institutions that originate (or are held) outside of Japan. For example, according to U.S. sources Japanese net purchases of U.S. debt securities were approximately $14 billion in 1986. But according to Japanese sources, net purchases of U.S. debt securities were over twice this amount, or approximately $32 billion during 1986. 97/

Currency values play a significant role in investors' decisions to purchase foreign securities since currency valuations can dramatically effect rates of return. For example, from year-end 1984 to year-end 1986, the S&P 500 stock index increased by 45 percent. But measured in Japanese yen, the index actually declined, and measured in German marks, the S&P 500 remained virtually unchanged.

The recent drop in the U.S. dollar has decreased the relative price of U.S. equities to certain foreign investors. Since late 1985, the U.S. dollar has declined sharply in value against the domestic currencies of Japan, Switzerland, Germany, and more recently, against the British pound sterling. Investors from these

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97/ Are Japanese Investors Diversifying, by N. Sargin & K. Schoenholtz, Salomon Brothers, Inc., and Nomura Investment Review (April 1987), page 11.

four countries were among the five most active participant groups in the U.S. market during 1986. Although the U.S. dollar remained relatively constant against the Canadian dollar, the geographic proximity and familiarity with U.S. equities contributed to Canada's position as one of the more active participants in the U.S. equity market.

Total U.S. activity in foreign securities (purchases and sales) also reached a record high in 1986 of $438.5 billion and represents a two-fold increase from 1985's record of $212 billion. As with foreign activity in U.S. securities, U.S. investors' trading in both foreign stocks and bonds reached record levels in 1986.

U.S. activity in foreign securities has traditionally been concentrated in the debt and equity issues of the United Kingdom and Japan. The equity markets of Japan and the United Kingdom are, respectively, the second and third largest in the world. During 1986, U.S. transactions in the debt and equity securities of these two countries accounted for 67 percent of the total activity by U.S. investors in foreign debt and equity issues.

The growth in international portfolio investment has been driven in part by the institutionalization of the savings investment process. In particular, there has been a tremendous growth in private pension fund investments and in mutual funds that invest on a global basis. The data presented in Table II-17 indicate that on a country by country basis foreign investment by private sector pension funds increased as a percent of total fund assets between 1980 and 1986.

Table II-17

OVERVIEW OF FOREIGN INVESTMENT BY PRIVATE SECTOR PENSION FUNDS
(US $ Millions)

Country	Foreign Investment		Foreign Investment as Percent of Total Assets	
	1980	1986	1980	1986
United States	$ 3,300	$45,000	1%	4%
United Kingdom	9,700	56,600	9	20
Japan	400	14,500	1	10
Canada	2,000	5,600	7	9
Netherlands	1,500	8,500	4	10
Switzerland	1,300	3,300	4	5
Germany	500	1,900	2	4
Australia	0	1,800	0	15
France	700	200	1	2
Rest of World	1,650	7,600	2%	4%
TOTAL	$21,050	$145,000		

Note: Estimated data converted at year-end exchange rates.

Source: InterSec Research Corporation

Foreign investment by U.S. private sector pension funds increased from an estimated $3.3 billion in 1980 to approximately $45.0 billion in 1986. Although a substantial increase, the percentage of assets invested by U.S. pension funds overseas is still small in relation to the foreign investments by pension funds in other countries. For example, in 1986, 20 percent of United Kingdom pension fund assets were invested in foreign securities. The $56.6 billion of foreign investment by United Kingdom pension funds was the largest of any country. If U.S. pension

funds were to increase their foreign investments to the average for other industrialized nations (8.8 percent of their assets), an additional $54 billion would be invested in foreign markets. 98/

K. Impact of Internationalization on U.S. Markets

There has been an international presence in the U.S. securities markets for at least a century. Strong investment ties have existed among the United Kingdom, Canada, and the U.S. and, more recently, the U.S., Japan and Western Europe. As noted above, there has been a dramatic increase in foreign portfolio investments in the U.S. and in U.S. investments in foreign securities markets. Part of the increase in U.S. portfolio investments in foreign markets reflects the trend in recent years for U.S. investors to purchase mutual funds and closed-end funds investing in foreign securities markets. These funds provide U.S. investors with another avenue into foreign securities markets as well as the diversification typically associated with mutual funds. The number of global mutual funds has increased from 21 in December 1983 to 59 in December 1986 (see Table II-18). The value of international fund sales also grew from $1.5 billion in 1984 to $7.6 billion during 1986. In addition to these global funds, there are about twelve U.S. exchange-listed closed-end country

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98/ This would also mean that the total U.S. pension fund investments ($99 billion) would exceed the equity market capitalization of either Australia or the Netherlands (see Table II-2).

Table II-18

OVERVIEW OF GLOBAL MUTUAL FUNDS
(U.S. $ Billions)

Year	Number of Funds	Global Fund Assets	Global Fund Sales
1983	21	$ 3.5	$ NA
1984	30	5.2	1.5
1985	42	7.9	1.8
1986	59	$15.9	$7.6

Source: Investment Company Institute

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funds investing in the securities of the emerging markets of Korea, Taiwan and Mexico as well as the developed markets such as France, Australia, Germany and Japan. The price performance of these closed-end funds investing in the securities markets of a specific foreign country varies considerably depending upon economic conditions in the home country as well as changes in currency values relative to the U.S. dollar.

Single country closed-end funds are a relatively new investment vehicle. The number of country funds grew from two in 1982 to eleven in 1986. 99/ The dollar volume of shares traded

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99/ The two closed-end country funds that were listed on U.S. exchanges prior to 1983 were the Japan Fund and the Mexico Fund. During 1983-1986, nine additional country funds were brought to the market through public offerings registered with the Commission. These funds invest in the securities of Australia (three funds), Taiwan, Korea, Sweden, Italy, Germany and France. On May 8, 1987, trading commenced on the NYSE in the newest closed-end country fund, the Malaysia Fund.

increased 17-fold from $75.9 million in 1982 to $1.3 billion in 1986. The rapid growth of mutual and closed-end funds investing internationally may be viewed as another indicator of strong U.S. investor interest in participating in foreign securities markets. Similar developments in London and in other overseas financial centers are another indicator of the internationalization of the world's securities markets.

An increase in U.S. demand for foreign securities is also evidenced by the number of foreign companies with securities traded through NASDAQ or on exchanges in the form of ADRs (see note 103, infra). Between 1982 and 1986 the number of ADRs traded through NASDAQ or on a stock exchange increased from 85 to 110. 100/ Most ADRs are traded through NASDAQ. In addition, there are several hundred more ADRs traded over-the-counter outside of NASDAQ. There also has been a substantial increase in the total number of ADR shares. Ten years ago there were roughly 150 million such shares outstanding in the U.S. In 1986, there were 2.4 billion shares outstanding; this represents a 16-fold increase over the past decade. 101/

Despite the growth of foreign stocks traded through ADRs there has been a decline in the number of foreign securities

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100/ ADRs: The Preferred Way to Trade," National Association of Securities Dealers (Washington, D.C. 1986).

101/ "Banks' Depository Receipt Business Sees Boom," American Banker, December 31, 1986, page 1.

listed on U.S. exchanges. In 1976 there were 175 foreign bond issues listed on U.S. exchanges. Ten years later there were 105 issues (see Table II-19). The number of foreign stocks (including ADRs) listed on U.S. exchanges increased only slightly from 115 in 1976 to 123 in 1986. The U.S. stock markets have not kept pace with other stock markets around the world in attracting foreign listings. As noted earlier, the Commission recently approved modifications to the American and NYSE listing standards. This may facilitate foreign listings in the U.S.

The U.S. domestic market has not kept pace with the trend toward internationalization in terms of the amount of capital raised in the U.S. securities market by foreigners. Throughout the last ten years, Yankee securities (foreign issues of stocks and bonds in the U.S.) registered with the SEC have remained generally in the four to six billion dollar range. Also, the number of foreign equity issues traded on U.S. exchanges has remained fairly constant. In 1977 there were 116 such issues. Ten years later there were 123. Foreign bonds traded on the U.S. exchanges have declined from 175 in 1977 to 105 in 1986.

A closer look at the Yankee securities markets shows how U.S. participation in the internationalization process has been uneven. The annual issuance of foreign securities registered with the SEC has not kept pace with the growth in international markets in debt and equity securities. While the issuance of foreign securities in the U.S. has not declined in nominal terms,

Table II-19

DOMESTIC AND FOREIGN SECURITIES
LISTED ON U.S. EXCHANGES
(Number of Issues)

	Equity		Bonds		Total	
Year	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
1976	3,746	116	2,923	175	6,669	291
1977	3,559	115	-	-	3,771	-
1978	3,459	106	2,961	177	6,420	283
1979	3,377	96	3,190	174	6,567	270
1980	3,557	99	3,350	157	6,907	256
1981	3,498	103	3,405	148	6,903	251
1982	3,530	103	3,579	134	7,109	237
1983	3,484	111	3,831	128	7,315	239
1984	3,421	114	4,043	121	7,464	235
1985	3,374	113	4,215	117	7,589	230
1986	3,360	123	4,002	105	7,362	228

Source: Directorate of Economic and Policy Analysis
Securities and Exchange Commission

it has declined in relative terms. In 1977 registered public offerings of foreign issues in the U.S. represented 13 percent of the dollar volume of our public new issues market (see Table II-20). In 1986 that portion dropped to three percent.

It is important to point out that foreign government debt represents by far the largest portion of capital raised by foreign entities in the U.S. securities market. In 1977 foreign governments accounted for 90 percent of capital raised through foreign public offerings registered with the SEC. By 1986 the figure had declined but still represented 64 percent of the

Table II-20

DOMESTIC CORPORATE FOREIGN ISSUES
REGISTERED AND OFFERED IN THE U.S.
(1977 - 1986)

Year	Domestic and Foreign Issues Combined ($billions)	Foreign Issues: Total ($billions)	Foreign Issues: Percent of Domestic and Foreign Combined
1977	$ 36.5	$4.7	13%
1978	32.9	4.4	13
1979	40.4	5.2	13
1980	67.4	4.3	6
1981	67.7	4.4	6
1982	74.6	2.5	3
1983	104.0	4.1	4
1984	89.2	4.3	5
1985	132.9	5.6	4
1986	$228.4	$6.4	3%

Note: The U.S. issues are corporate debt and business equity issues. The foreign issues also include government debt offerings. Cash offerings are included while secondary and exchange offerings are excluded. Also note that the OECD figures on foreign new issues in the U.S. reported in Table 8 differ somewhat from those in this table. The difference is accounted for by the OECD including certain private placements and exempt offerings while under-reporting registered issues in some years.

Source: Directorate of Economic and Policy Analysis
Securities and Exchange Commission

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total. The remainder of the market has fluctuated between corporate debt and equity. In 1986 equity accounted for 26 percent and corporate debt for 10 percent of total foreign offerings. 102/

Canada is by far the most frequent user of the Yankee securities market. Canadian disclosure and accounting standards are

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102/ See Appendix Tables II-O and II-P for further details on registered foreign offerings in the U.S. primary market.

similar to those of the U.S., making it easier for Canadian entities to raise capital in the U.S. Canadian issuers accounted for roughly half of all foreign debt and equity offerings during the ten-year period ending in 1986 (see Table II-21). With regard to corporate debt offerings, Japan had the next highest number (9) after Canada (36). With regard to equity offerings, Bermuda with 29 was second to Canada with 277. For government debt, Sweden (13 issues) was next after Canada (70 issues) over this ten-year period.

Another aspect of the Yankee securities markets is the extent of secondary market trading in foreign securities. Table II-22 shows the number of ADRs registered for trading in the U.S. 103/ The number registered has fluctuated considerably over the last ten years but generally increased in the last three years. In 1981 there were 106 ADRs newly registered with the Commission. In 1982 only 45 were registered. The number rose to 288 registrations in 1985 then dropped to 204 in 1986. Many of these ADRs, however, are the registrations of additional shares of issues already traded in the U.S. Some of the ADR registrations represent the introduction of new foreign issues into the U.S. market. The leading sources of ADRs over the last 10 years have

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103/ American Depository Receipts are negotiable certificates created by transfer agents and U.S. banks to facilitate trading of foreign securities. Dividend distributions and other transfer agent and custodial functions are conducted by the U.S. bank or intermediaries.

Table II-21

FOREIGN SECURITIES REGISTERED IN THE U.S. BY ISSUER'S COUNTRY OF ORIGIN: 1977-1986 COMBINED
(Number of Registrations)

	Corporate Debt	Corporate/ Business Equity	Government Debt	ADRs	Total
Africa, Middle East					
South Africa	1	3	-	142	146
Israel	3	21	9	3	36
All Others	-	-	-	4	4
Asia					
Japan	9	10	6	149	174
Hong Kong	-	2	-	69	71
Singapore	-	-	-	25	25
All Others	-	1	3	7	11
Caribbean, Central and South America					
Bermuda	1	29	-	8	38
Netherland Antilles	1	11	-	2	14
Bahamas	-	11	-	1	12
All Others	1	21	3	3	28
Europe, Australia					
Australia	4	3	4	308	319
United Kingdom	2	23	1	174	200
Sweden	1	5	13	19	38
W. Germany	-	-	-	34	34
France	-	4	11	16	31
All Others	6	35	41	51	133
North America					
Canada	36	277	70	9	392
Mexico	1	3	2	8	14
	66	459	163	1,032	1,720

Source: Directorate of Economic and Policy Analysis
Securities and Exchange Commission

Table II-22

TYPES OF FOREIGN SECURITIES REGISTERED WITH THE SEC: 1977-1986

(Number of Issues)

	Corporate Debt	Corporate/ Business Equity	Government Debt	ADRs	Total
1977	1	22	34	35	92
1978	2	21	19	31	73
1979	4	29	18	58	109
1980	8	49	9	66	132
1981	15	48	26	106	195
1982	6	32	17	45	100
1983	12	84	15	60	171
1984	3	44	9	139	195
1985	6	80	5	288	379
1986	9	50	11	204	274

Source: Directorate of Economic and Policy Analysis
Securities and Exchange Commission

been Australia (308 registrations), the United Kingdom (174), Japan (149), and South Africa (142) (see Table II-21).

The trend towards internationalization is also evident in international acquisitions of U.S. and foreign corporations (see Table II-23). U.S. acquisitions of foreign companies reached a record 180 in 1986, and the disclosed dollar value of these acquisitions also reached a record \$5.2 billion. Similarly, the number of foreign acquisitions of U.S. companies reached a high of 264, while the disclosed dollar volume of these transactions equalled \$24.5 billion.

Table II-23

INTERNATIONAL ACQUISITIONS OF U.S.
AND FOREIGN COMPANIES
(U.S. $ Billions)

	Foreign Acquisitions of U.S. Companies		U.S. Acquisitions of Foreign Companies	
Year	Number	Dollar Value	Number	Dollar Value
1975	184	$ 1.6	178	$ 0.4
1980	187	7.1	102	3.8
1981	234	18.8	101	1.1
1982	154	5.1	121	0.8
1983	125	5.9	146	2.5
1984	151	15.1	147	2.6
1985	197	10.9	175	1.5
1986	264	$24.5	180	5.2

Note: This data must be interpreted with care. The dollar value of transactions is based upon those transactions that disclosed a purchase price, not the total number of transactions reported in the above table.

Source: Mergerstat Review, The W.T. Grimm & Co.

Another example of the impact of internationalization on U.S. corporations is the extent to which they now conduct overseas bond financing. U.S. corporations raised $5.8 billion through international bonds and $41.9 billion in registered domestic bond offerings in 1980. The international bonds represented 12 percent of the total $47.7 billion raised in the two markets. By 1986 international bond financing rose to $44 billion while domestic registered bond financing was $157 billion.

Thus in 1986 international bonds rose to 22 percent of the total capital raised in these two markets by U.S. issuers. 104/

L. Future Prospects

The internationalization of the world's securities markets presents new challenges and opportunities for the U.S. securities markets and its regulators. In recent years the international financial landscape has changed in response to economic, institutional, technological, and regulatory forces. While the future cannot be predicted with any degree of certainty, it does appear that the securities markets are likely to maintain their global character in the years ahead.

During the 1980's the world's capital markets became more interdependent. At the same time, the securities markets assumed a larger role in the international capital market. This was due in part to favorable economic conditions and regulatory liberalizations, such as the elimination of exchange controls in Japan and the United Kingdom, that contributed to the expansion of both domestic and international securities markets around the world. Technology also played a role in this process. In a very real sense, the world is getting smaller due to improvements in technology and reduced information costs.

104/ Appendix Tables II-A to II-B and II-C provide information on international financing by issuers country of origin.

The U.S. markets have played a large role in shaping global trends in securities. In particular, the U.S. markets are highly competitive and innovative. They remain the largest, most sophisticated in the world with the widest range of financial products available to market participants.

The U.S. regulatory structure also appears to have had an impact on other major capital markets around the world. The reductions in transactions costs associated with the deregulation of commission rates in the U.S. exerted pressure on other markets. The benefits that result from vigorous competition have not gone unnoticed in other financial centers. Regulatory restructuring is now occurring in the capital markets of, among others, the United Kingdom, Canada, Japan, and France.

Looking back, the 1960's may be characterized as the decade when the internationalization of the securities markets began its latest phase. The 1970's may be viewed as the decade when the U.S. securities markets entered into a major restructuring, some of which resulted from the Securities Acts Amendments of 1975. This restructuring, the increased competition, and the financial innovation in the U.S. during this decade helped influence the character and pace of regulatory changes in other securities markets.

The 1980's may be viewed as a decade of rapid growth for international transactions in securities and a time when many other financial centers undertook major restructuring of their

markets. Regulatory liberalization resulted in increased competition in domestic financial markets and permitted greater foreign participation which accelerated the process of internationalization. The 1990's may present opportunities for further growth and integration of international securities markets and the challenge to develop a global regulatory framework that preserves the efficiencies associated with international capital mobility.

Appendix Table II-A

EUROBOND ISSUES BY BORROWER'S COUNTRY OF ORIGIN
(U.S. $ Millions)

Country	1975	1980	1981	1982	1983	1984	1985	1986
United States	$ 268	$ 4,395	$ 6,110	$13,049	$ 6,114	$21,491	$ 36,348	$ 38,643
Japan	1,133	1,746	4,625	4,584	6,953	11,002	14,897	25,351
United Kingdom	176	1,520	1,229	1,090	1,525	4,736	14,987	18,538
Canada	870	1,412	5,533	6,958	3,866	4,488	6,980	13,640
Germany	87	*	110	1,304	2,451	1,661	3,063	10,184
Australia	356	201	320	587	1,201	2,182	3,680	7,819
Switzerland	139	355	*	600	845	496	864	1,947
France	1,231	1,754	2,278	6,917	6,103	7,020	10,240	12,510
Italy	17	979	1,110	836	1,204	3,588	4,993	4,842
Netherlands	438	914	294	759	1,112	1,034	1,159	2,725
Other OECD	3,306	5,246	4,672	7,436	14,223	18,056	25,743	42,646
Oil Exporters	50	132	200	470	338	425	650	420
Non-oil LDCs	179	1,018	2,945	3,156	1,660	2,252	5,720	2,517
Eastern Europe	141	50	50	*	*	*	408	291
Other Countries	333	172	250	316	646	826	1,388	924
International Development Banks	19	500	1,568	2,267	1,857	2,460	4,311	3,955
TOTAL	$8,743	$20,394	$31,294	$50,329	$50,098	$81,717	$135,431	$186,952

* Nil or no transaction

NOTE: Data may not add due to rounding. "Other OECD" includes European based development banks.

SOURCE: OECD Financial Statistics Monthly (various issues)

Appendix Table II-B

FOREIGN BOND ISSUES BY BORROWER'S COUNTRY OF ORIGIN
(U.S. $ Millions)

Country	1975	1980	1981	1982	1983	1984	1985	1986
United States	$ 142	$ 1,369	$ 697	$ 1,787	$ 1,241	$ 1,462	$ 3,195	$ 5,022
Japan	482	2,043	2,096	3,687	6,678	6,035	6,203	9,020
United Kingdom	300	66	156	187	553	261	266	872
Canada	3,534	1,744	5,448	4,442	2,908	1,761	2,505	2,757
Germany	140	157	133	97	470	403	105	951
Australia	327	236	343	1,357	1,085	1,117	2,023	2,463
Switzerland	31	*	*	*	*	88	*	*
France	595	679	841	1,278	1,231	1,524	1,185	893
Italy	44	102	101	187	255	131	259	587
Netherlands	241	212	478	112	74	97	392	545
Other OECD	2,713	7,219	5,550	6,377	6,942	8,141	6,515	9,449
Oil Exporters	18	46	242	71	78	107	134	36
Non-Oil LDCs	466	507	878	451	549	834	1,417	1,467
Eastern Europe	*	*	*	*	*	41	39	*
Other Countries	106	193	108	177	268	396	165	127
International Development Banks	2,078	3,351	3,443	4,989	4,718	5,403	6,622	4,252
TOTAL	$11,217	$17,924	$20,514	$25,199	$27,050	$27,801	$31,025	$38,441

* Nil or no transaction

NOTE: Data may not add due to rounding. "Other OECD" includes European based development banks.

SOURCE: OECD Financial Statistics Monthly (various issues)

Appendix Table II-C

INTERNATIONAL BOND ISSUES BY BORROWER'S COUNTRY OF ORIGIN
(U.S. $ Millions)

Country	1975	1980	1981	1982	1983	1984	1985	1986
United States	$ 410	$ 5,764	$ 6,807	$14,836	$ 7,355	$ 22,953	$ 39,543	$ 43,665
Japan	1,615	3,789	6,721	8,271	13,631	17,037	21,100	34,371
United Kingdom	476	1,586	1,385	1,277	2,078	4,997	15,253	19,410
Canada	4,404	3,156	10,981	11,400	6,774	6,249	9,485	16,397
Germany	227	157	243	1,401	2,921	2,064	3,168	11,135
Australia	683	437	663	1,944	2,285	3,299	5,703	10,282
Switzerland	170	355	*	600	845	584	864	1,947
France	1,826	2,433	3,119	8,195	7,334	8,544	11,425	13,403
Italy	61	1,081	1,211	1,023	1,459	3,719	5,252	5,429
Netherlands	679	1,126	772	871	1,186	1,131	1,551	3,270
Other OECD	6,019	12,465	10,222	13,813	21,165	26,197	32,258	52,095
Oil Exporters	68	178	442	541	416	532	784	456
Non-oil LDCs	645	1,525	3,823	3,607	2,209	3,086	7,137	3,984
Eastern Europe	141	50	50	*	*	41	447	291
Other Countries	439	365	358	493	915	1,222	1,553	1,051
International Development Banks	2,097	3,851	5,011	7,256	6,575	7,863	10,933	8,207
TOTAL	$19,960	$38,318	$51,808	$75,528	$77,148	$109,518	$166,456	$225,393

* Nil or no transaction

NOTE: Data may not add due to rounding. Data includes both Eurobonds and foreign bonds. "Other OECD" includes European based development banks.

SOURCE: OECD Financial Statistics Monthly (various issues)

Appendix Table II-D

MARKET SHARE OF LEAD MANAGERS IN THE EUROBOND AND EUROEQUITY MARKETS
(U.S. $ Billions)

Eurobond Market

Lead Managers	1986 Dollars	1986 % Market Share	1986 Issues	1985 Dollars	1985 % Market Share	1985 Issues
Largest	$ 19.8	10.8%	102	$19.2	14.3%	103
Top 5	65.9	36.0	475	43.0	31.9	344
Top 10	101.1	55.3	763	70.5	52.4	612
Top 20	$135.3	74.1%	1,072	$95.8	71.3%	860

Euroequity Market

Lead Managers	1986 Dollars	1986 % Market Share	1986 Issues	1985 Dollars	1985 % Market Share	1985 Issues
Largest	$ 2.7	19.2%	6	$ 1.8	37.8%	2
Top 5	8.1	57.7	55	4.0	85.9	30
Top 10	11.1	79.4	102	4.5	96.1	37
Top 20	$ 14.0	97.0%	132	$ 4.6	99.9%	49

SOURCES: Institutional Investor (various issues), London Financial Times, January 5, 1987

Appendix Table II-E

PERFORMANCE OF STOCK PRICE INDICES IN TEN MAJOR COUNTRIES

Index Value in Local Currency

Country	1981	1982	1983	1984	1985	1986
United States	50.71	59.57	69.38	69.75	88.25	100.00
Japan	35.16	36.83	45.55	57.25	64.96	100.00
Germany	32.10	36.65	50.27	54.83	95.37	100.00
Canada	62.07	62.60	81.36	79.39	94.37	100.00
United Kingdom	38.03	46.95	57.90	71.99	82.79	100.00
Italy	21.19	18.52	22.44	28.41	57.56	100.00
Switzerland	43.76	47.62	58.79	59.17	91.02	100.00
France	25.14	25.88	40.68	47.54	67.99	100.00
Netherlands	35.66	41.21	62.41	76.53	96.54	100.00
Australia	42.87	34.96	56.32	50.14	70.66	100.00

Index Value in U.S. Dollars

Country	1981	1982	1983	1984	1985	1986
United States	50.71	59.57	69.38	69.75	88.25	100.00
Japan	25.34	24.85	31.12	36.08	51.32	100.00
Germany	27.63	29.71	35.47	33.43	74.93	100.00
Canada	72.26	70.31	90.24	82.94	93.20	100.00
United Kingdom	49.10	51.29	56.26	56.32	80.75	100.00
Italy	23.75	18.24	18.09	19.72	46.14	100.00
Switzerland	39.82	38.58	43.95	37.18	71.22	100.00
France	28.32	24.60	31.23	31.59	57.72	100.00
Netherlands	31.92	34.48	45.00	47.45	76.71	100.00
Australia	72.74	51.64	76.33	62.26	72.49	100.00

NOTE: The indices used are the "Financial Times-Actuaries World Indices." The numbers represent end of year values with 1986 = 100.

SOURCE: World Equity Market Results, 1981-1986, Goldman Sachs International Research

Appendix Table II-F

ANNUAL RATES OF RETURN OF STOCK PRICE INDICES IN TEN MAJOR COUNTRIES
(In Percent)

Return Value in Local Currency

Country	1981	1982	1983	1984	1985	1986
United States	-8.94%	17.83%	15.78%	1.49%	24.49%	14.04%
Japan	19.15	5.33	21.73	25.09	13.22	46.05
Germany	-0.81	13.78	33.53	9.60	58.07	6.97
Canada	-12.98	3.74	27.54	-1.55	18.08	6.32
United Kingdom	9.67	21.85	21.68	23.51	14.92	20.25
Italy	14.53	-12.04	20.94	26.07	73.52	64.42
Switzerland	-13.80	9.11	21.62	1.06	44.82	10.93
France	-17.85	4.19	46.42	17.34	38.13	41.94
Netherlands	-5.25	15.68	43.58	23.55	24.07	4.66
Australia	-21.16%	-18.13%	51.27%	-9.83%	35.58%	36.68%

Return Value in U.S. Dollars

Country	1981	1982	1983	1984	1985	1986
United States	-8.95%	17.83%	15.78%	1.47%	24,50%	14.05%
Japan	11.75	1.48	23.27	18.15	36.43	72.37
Germany	-12.66	8.59	20.14	-4.93	84.98	33.92
Canada	-11.75	1.31	26.32	-7.28	12.47	7.74
United Kingdom	-11.17	5.20	10.63	1.44	39.16	24.26
Italy	-12.52	-24.16	0.62	11.07	88.96	88.33
Switzerland	-12.47	-1.26	13.49	-15.68	68.35	36.37
France	-38.20	-11.11	24.32	2.62	63.81	60.73
Netherlands	-18.99	9.92	28.32	7.87	49.88	27.91
Australia	-24.49%	-31.06%	43.09%	-17.80%	18.01%	37.74%

NOTE: Values for the annual rate of return are derived from the "Financial Times-Actuaries World Indices."

SOURCE: World Equity Market Results, 1981-1986, Goldman Sachs International Research

Appendix Table II-G

TRADING VOLUME AND TURNOVER OF WORLD'S MAJOR STOCK MARKETS

Trading Volume (U.S. $ Billions)

Country	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
United States	$166	$226	$272	$410	$416	$508	$797	$786	$997	$1374
Japan	90	168	145	161	224	147	231	285	388	1001
United Kingdom	19	20	27	36	33	33	43	48	76	230
Germany	13	19	15	15	14	14	33	30	84	150
Canada	5	9	16	25	21	14	24	20	32	64
Switzerland	56	62	70	79	75	N.A.	127	131	215	340
France	3	10	10	10	8	7	8	8	17	69
Australia	1	1	5	5	8	5	9	11	15	26
Netherlands	8	10	9	5	4	5	10	12	20	67
Italy	$ 1	$ 2	$ 4	$ 9	$ 11	$ 3	$ 4	$ 4	$ 14	$ 49

Turnover: Dollar Volume as Percent of Capitalization

Country	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
United States	.20	.26	.27	.33	.37	.39	.50	.50	.49	.62
Japan	.42	.49	.50	.42	.54	.35	.42	.41	.41	.56
United Kingdom	.16	.16	.18	.18	.17	.17	.19	.20	.21	.46
Germany	.20	.23	.19	.21	.22	.20	.40	.38	.47	.65
Canada	.09	.13	.17	.21	.20	.14	.17	.15	.20	.34
Switzerland	1.87	1.63	1.63	1.84	1.97	N.A.	2.89	3.28	2.56	2.67
France	.11	.22	.18	.18	.21	.23	.21	.20	.22	.46
Australia	.05	.04	.13	.08	.15	.12	.15	.22	.25	.22
Netherlands	.35	.37	.31	.17	.17	.19	.29	.34	.34	.81
Italy	.17	.20	.31	.36	.46	.15	.19	.15	.24	.35

N.A. - Not Available

SOURCE: Goldman Sachs International Investment Research, September 1986; International Equity Analysis, June 1987, Salomon Brothers Inc.

Appendix Table II-H

FOREIGN EXCHANGE RATES: CURRENCIES PER U.S. DOLLAR
(Average per Quarter)

	Australia	Canada	France	Germany	Italy	Japan	Netherlands	Switzerland	United Kingdom
1980 Q1	0.91	1.16	4.15	1.77	824.80	243.54	1.95	1.66	0.44
Q2	0.89	1.17	4.21	1.81	851.50	232.69	1.99	1.68	0.44
Q3	0.86	1.16	4.12	1.78	843.50	220.08	1.94	1.63	0.42
Q4	0.85	1.18	4.42	1.91	906.10	210.65	2.07	1.72	0.42
1981 Q1	0.86	1.19	4.86	2.09	1,001.40	205.57	2.28	1.90	0.43
Q2	0.88	1.19	5.42	2.28	1,134.10	220.00	2.53	2.03	0.48
Q3	0.88	1.21	5.81	2.43	1,215.40	231.89	2.70	2.10	0.54
Q4	0.88	1.19	5.65	2.24	1,196.20	224.68	2.47	1.83	0.53
1982 Q1	0.92	1.21	5.99	2.35	1,261.80	223.49	2.58	1.87	0.54
Q2	0.95	1.24	6.28	2.38	1,319.30	244.15	2.64	1.99	0.56
Q3	1.02	1.25	6.94	2.48	1,393.60	258.86	2.73	2.11	0.58
Q4	1.05	1.23	7.07	2.50	1,435.20	259.68	2.74	2.14	0.61
1983 Q1	1.06	1.23	6.89	2.41	1,399.40	235.74	2.66	2.02	0.65
Q2	1.06	1.23	7.47	2.48	1,477.50	237.53	2.79	2.08	0.64
Q3	1.14	1.23	7.96	2.64	1,573.70	242.53	2.96	2.15	0.66
Q4	1.10	1.24	8.17	2.68	1,624.80	234.24	3.00	2.16	0.68
1984 Q1	1.08	1.26	8.31	2.70	1,662.40	231.01	3.05	2.20	0.70
Q2	1.11	1.29	8.33	2.71	1,675.40	229.61	3.05	2.25	0.72
Q3	1.19	1.31	8.96	2.92	1,799.50	243.46	3.29	2.44	0.77
Q4	1.18	1.32	9.36	3.05	1,890.50	246.02	3.45	2.51	0.82
1985 Q1	1.33	1.35	9.96	3.26	2,021.10	257.68	3.68	2.76	0.90
Q2	1.49	1.37	9.41	3.09	1,970.70	250.73	3.49	2.59	0.80
Q3	1.43	1.36	8.69	2.85	1,895.60	238.64	3.21	2.35	0.73
Q4	1.45	1.38	7.89	2.58	1,750.30	207.09	2.91	2.13	0.70
1986 Q1	1.43	1.40	7.21	2.35	1,598.20	187.88	2.65	1.98	0.69
Q2	1.40	1.38	7.15	2.25	1,539.00	170.13	2.53	1.87	0.66
Q3	1.61	1.39	6.78	2.09	1,435.80	155.77	2.35	1.69	0.67
Q4	1.54	1.38	6.57	2.01	1,390.20	160.29	2.27	1.66	0.70

NOTE: Currencies reflect average values per U.S. dollar during the quarter. Local currencies used are as follows: Australian dollar, Canadian dollar, French Franc, German Mark, Italian Lira, Japanese Yen, Dutch Guilder, Swiss Franc and British Pound.

SOURCE: International Financial Statistics (various issues)
International Monetary Fund

Appendix Table II-I

INTERNATIONAL PORTFOLIO INVESTMENT TRENDS
(U.S. $ Billions)

Year	Foreign Purchases and Sales of U.S. Securities			U.S. Purchases and Sales of Foreign Securities		
	Stocks	Bonds	Total	Stocks	Bonds	Total
1975	$ 26.0	$ 25.9	$ 51.9	$ 3.3	$ 11.1	$ 14.4
1976	33.7	53.0	86.7	4.2	18.6	22.8
1977	25.6	65.2	90.8	4.9	21.2	26.1
1978	37.9	73.7	111.6	6.8	26.4	33.2
1979	43.9	96.3	140.2	10.1	29.3	39.4
1980	75.2	122.9	198.1	17.9	35.2	53.1
1981	75.5	151.4	227.0	18.9	40.6	59.5
1982	79.9	216.5	296.4	15.7	61.0	76.6
1983	134.1	301.0	435.1	30.3	75.9	106.2
1984	122.6	516.9	639.5	30.7	116.0	146.7
1985	159.0	1,126.2	1,285.2	45.7	166.4	212.1
1986	$277.6	$2,277.0	$2,554.6	$102.0	$336.5	$438.5

SOURCE: U.S. Treasury Bulletin (various issues)

Appendix Table II-J

INTERNATIONAL TRANSACTIONS IN U.S. AND FOREIGN DEBT SECURITIES
(U.S. $ Millions)

Year	Foreign Activity in U.S. Debt Securities			U.S. Activity in Foreign Debt Securities		
	Purchases	Sales	Net Capital Flow	Purchases	Sales	Net Capital Flow
1975	$ 14,306	$ 11,545	$ 2,761	$ 8,720	$ 2,383	$-6,337
1976	31,139	21,841	9,298	13,706	4,932	-8,774
1977	46,574	18,666	27,908	13,136	8,040	-5,096
1978	40,347	33,339	7,008	15,326	11,101	-4,225
1979	50,138	46,136	4,002	16,660	12,662	-3,998
1980	66,595	56,262	10,333	18,090	17,090	-1,000
1981	85,763	65,677	20,086	23,013	17,553	-5,460
1982	117,632	98,863	18,769	33,809	27,167	-6,642
1983	153,680	147,351	6,329	39,572	36,333	-3,239
1984	275,634	241,237	34,397	59,948	56,017	-3,931
1985	585,174	541,042	44,132	85,214	81,216	-3,998
1986	$1,176,027	$1,100,951	$75,076	$169,798	$166,700	$-3,098

SOURCE: U.S. Treasury Bulletin (various issues)

Appendix Table II-K

INTERNATIONAL TRANSACTIONS IN U.S. AND FOREIGN CORPORATE STOCKS
(U.S. $ Millions)

Year	Foreign Activity in U.S. Stocks			U.S. Activity in Foreign Stocks		
	Purchases	Sales	Net Capital Flow	Purchases	Sales	Net Capital Flow
1975	$ 15,355	$ 10,678	$ 4,677	$ 1,730	$ 1,542	$ -188
1976	18,227	15,475	2,752	2,259	1,937	-322
1977	14,154	11,479	2,675	2,665	2,255	-410
1978	20,145	17,723	2,422	3,139	3,666	527
1979	22,783	21,104	1,679	5,434	4,617	-817
1980	40,298	34,870	5,428	10,044	7,897	-2,147
1981	40,686	34,856	5,830	9,586	9,339	-247
1982	41,881	37,981	3,900	8,504	7,163	-1,341
1983	69,770	64,360	5,410	17,046	13,281	-3,765
1984	59,834	62,814	-2,980	15,917	14,816	-1,101
1985	81,995	77,054	4,941	24,803	20,861	-3,942
1986	$148,134	$129,436	$18,698	$51,744	$50,292	$-1,452

SOURCE: U.S. Treasury Bulletin (various issue)

Appendix Table II-L

INTERNATIONAL TRANSACTIONS IN DEBT SECURITIES BY COUNTRY
(U.S. $ Millions)

Country	Foreign Activity in U.S. Debt Securities 1982	1983	1984	1985	1986
Japan	$ 14,339	$ 18,125	$ 34,205	$ 185,295	$ 618,828
United Kingdom	51,195	57,619	112,784	249,148	531,954
Germany	19,377	17,108	29,951	39,164	68,130
Canada	3,649	8,706	22,805	44,874	80,111
Switzerland	5,552	8,201	11,544	25,278	59,593
France	4,060	5,295	8,972	13,514	22,779
Italy	52	93	161	336	1,208
Australia	62	250	674	5,524	8,938
Netherlands	7,383	9,364	10,409	11,250	22,862
All Other	110,826	176,270	285,366	551,833	862,575
Total	$216,495	$301,031	$516,871	$1,126,216	$2,276,978

Country	U.S. Activity in Foreign Debt Securities 1982	1983	1984	1985	1986
Japan	$10,739	$10,747	$ 24,253	$ 33,852	$ 84,976
United Kingdom	22,473	33,650	52,492	72,652	150,782
Germany	1,197	919	1,623	3,210	12,891
Canada	7,084	7,589	8,734	12,624	16,529
Switzerland	1,414	2,056	2,803	2,751	4,842
France	2,033	2,356	3,140	2,866	4,764
Italy	50	49	94	214	539
Australia	442	945	190	549	2,711
Netherlands	298	461	530	594	1,466
All Other	15,246	17,133	22,106	37,118	56,998
Total	$60,976	$75,905	$115,965	$166,430	$336,498

NOTE: Data includes both purchases and sales.

SOURCE: U.S. Treasury Bulletin (various issues)

Appendix Table II-M

INTERNATIONAL TRANSACTIONS IN CORPORATE STOCK BY COUNTRY
(U.S. $ Millions)

Country	Foreign Activity in U.S. Stocks 1982	1983	1984	1985	1986
Japan	$ 1,991	$ 3,257	$ 2,748	$ 7,805	$ 27,003
United Kingdom	18,785	28,206	27,516	37,622	64,584
Germany	3,382	7,536	6,163	6,136	10,659
Canada	10,033	16,423	16,752	22,141	34,575
Switzerland	14,214	26,192	20,052	21,605	36,982
France	5,010	7,990	5,658	6,041	9,581
Italy	171	250	162	269	987
Australia	323	848	834	1,364	3,087
Netherlands	2,083	4,030	3,457	3,956	6,245
All Other	23,870	39,398	39,306	52,110	83,866
Total	$79,862	$134,130	$122,648	$159,049	$277,570

Country	U.S. Activity in Foreign Stocks 1982	1983	1984	1985	1986
Japan	$ 4,331	$ 8,244	$ 9,099	$11,584	$ 28,175
United Kingdom	3,619	6,683	7,933	13,310	32,553
Germany	517	1,242	866	1,909	6,127
Canada	2,939	4,969	4,426	6,838	9,836
Switzerland	706	1,778	1,322	1,633	3,218
France	801	1,440	1,012	1,225	3,958
Italy	8	182	105	458	1,096
Australia	154	383	425	872	1,607
Netherlands	434	1,153	1,308	1,914	3,777
All Other	2,158	4,253	4,237	5,919	11,689
Total	$15,667	$30,327	$30,733	$45,664	$102,036

NOTE: Data includes both purchases and sales.

SOURCE: U.S. Treasury Bulletin (various issues)

Appendix Table II-N

DOMESTIC AND FOREIGN SECURITIES LISTED ON U.S. EXCHANGES

Year	Equity				Bonds				Total			
	Domestic		Foreign		Domestic		Foreign		Domestic		Foreign	
	Number of Issues	(U.S. $ Billions)	Number of Issues	(U.S. $ Billions)	Number of Issues	(U.S. $ Billions)	Number of Issues	(U.S. $ Billions)	Number of Issues	(U.S. $ Billions)	Number of Issues	(U.S. $ Billions)
1976	3,746	$ 899	116	$31	2,923	$ 403	175	$ 5	6,669	$1,301	291	$ 37
1977	3,559	837	115	32	-	-	-	-	3,771	837	-	32
1978	3,459	828	106	37	2,961	462	177	8	6,520	1,290	283	45
1979	3,377	1,021	96	57	3,190	464	174	8	6,567	1,485	270	65
1980	3,557	1,350	99	81	3,350	514	157	8	6,907	1,864	256	89
1981	3,498	1,238	103	70	3,405	582	148	8	6,903	1,820	251	78
1982	3,530	1,390	103	63	3,579	776	134	9	7,109	2,166	237	72
1983	3,484	1,609	111	85	3,831	900	128	9	7,315	2,509	239	93
1984	3,421	1,587	114	74	4,043	1,026	121	10	7,464	2,613	235	84
1985	3,374	1,952	113	90	4,215	1,348	117	10	7,589	3,300	230	101
1986	3,360	$ 2,206	123	$94	4,002	$1,471	105	$11	7,362	$3,676	228	$105

SOURCE: Directorate of Economic and Policy Analysis

Appendix Table II-O

VOLUME OF DOMESTIC AND FOREIGN ISSUES REGISTERED AND OFFERED IN THE U.S

Volume U.S. $ Millions

	Domestic and Foreign Issues Combined			Foreign Issues			
				Corporate Issues		Government Issues	
Year	Debt	Equity	Total	Debt	Equity	Debt	Total
1977	$ 26,213	$10,299	$ 36,512	$ 50	$ 414	$4,248	$4,712
1978	23,319	9,614	32,933	270	40	4,101	4,411
1979	29,216	11,174	40,390	480	454	4,273	5,207
1980	44,452	22,902	67,354	582	1,669	2,009	4,260
1981	40,487	27,188	67,675	894	298	3,194	4,386
1982	45,994	28,572	74,566	769	484	1,275	2,528
1983	51,053	52,921	103,974	714	1,865	1,568	4,174
1984	62,877	26,370	89,247	129	750	3,394	4,273
1985	90,120	42,806	132,926	689	1,110	3,841	5,640
1986	$162,230	$66,213	$228,443	$661	$1,639	$4,102	$6,402

Number of Issues

				Corporate Issues		Government Issues	
Year	Debt	Equity	Total	Debt	Equity	Debt	Total
1977	427	544	971	1	8	42	51
1978	373	673	1,046	3	4	26	33
1979	361	772	1,133	3	6	23	32
1980	588	1,392	1,980	8	21	14	43
1981	502	1,807	2,309	9	21	21	51
1982	674	1,432	2,106	9	13	21	43
1983	716	2,679	3,395	14	66	12	92
1984	664	1,867	2,531	3	22	11	36
1985	1,123	2,018	3,141	4	35	16	55
1986	1,622	2,862	4,484	4	27	21	52

NOTE: The U.S. domestic issues are corporated debt and business equity issues. The foreign issues also include government debt offerings. Cash offerings are included while secondary and exchange offers are excluded.

SOURCE: Directorate of Economic and Policy Analysis

Appendix Table II-P

DISTRIBUTION OF FOREIGN ISSUES REGISTERED AND OFFERED IN THE U.S.

	Total (U.S. $ Billions)	Foreign Issues as a Percent of Foreign and Domestic Combined	Type of Foreign Issues as a Percent of Total				Canadian Issues as a Percent of All Foreign Issues
			Corporate Debt	Corporate/ Business Equity	Government Debt	Total	
1977	$4.7	13%	1%	9%	90%	100%	30%
1978	4.4	13	6	1	93	100	58
1979	5.2	13	9	9	82	100	43
1980	4.3	6	14	39	47	100	68
1981	4.4	6	20	7	73	100	87
1982	2.5	3	30	19	51	100	70
1983	4.1	4	17	45	38	100	55
1984	4.2	5	3	18	79	100	26
1985	5.6	4	12	18	70	100	42
1986	$6.4	3%	1%	39%	65%	100%	23%

SOURCE: Directorate of Economic and Policy Analysis

CHAPTER III

Disclosure and Distribution Standards in Relation to Multinational and International Issues of Securities

Prepared by the Division of Corporation Finance

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CHAPTER III

DISCLOSURE AND DISTRIBUTION STANDARDS IN RELATION TO MULTINATIONAL AND INTERNATIONAL ISSUES OF SECURITIES

I. INTRODUCTION

This chapter of the staff's report centers on issues of importance in the areas of international and multinational finance. The financing techniques described herein are important to all issuers of securities who may turn to the international financial markets in an effort to maximize the returns on their capital-raising activities. The chapter outlines the procedures such persons must follow in order to comply with statutory and regulatory requirements under various legal systems. Legal and regulatory systems in the United States and several foreign countries are discussed, with particular emphasis given the international aspects of securities regulation.

The beginning of the chapter gives an introduction and brief analysis of the international financial markets, distinguishing them from the domestic markets around the world. The international financial markets, while possessing a character of their own and enjoying a relative freedom from domestic regulation, are nevertheless affected by the laws of the countries in which their participants reside. The effects of some of these regulations on the development and growth of the international financial markets are noted. This discussion also includes a description of the international money markets and new

evolution of the international capital markets, including the emergence of the Eurobond market, is also analyzed.

Following the discussion of the international marketplace, there is an overview of United States distribution and disclosure practices that affect foreign issuers. Registration provisions for foreign issuers, the use of American depositary receipts, and a brief outline of the statutory liability provisions are included.

The disclosure requirements and distribution practices for securities issued or sold in the European Economic Community and eight major industrialized nations 1/ other than the United States are then set forth. Several EEC Directives relating to efforts toward harmonization of the member states' stock exchange listing regulations and accounting practices are mentioned. The discussion then focuses on the regulatory structure in the eight countries and the nature of their implementing authorities. The major securities markets are identified as are the means by which securities are issued into these markets. Other details of the different securities regulations in these countries are given where relevant.

1/ The countries included in this study are the United Kingdom, Japan, Canada, West Germany, France, Australia, Switzerland, and the Netherlands. Due to time and space limitations, the study of other countries was not undertaken. The inclusion of these countries and the exclusion of others should not be taken to imply any qualitative distinctions, nor are any intended.

The tender offer rules of the United States and several major nations are outlined and compared in a separate section. Finally, some insight into the problems facing issuers and the Commission is provided. In this regard, special emphasis is given to those issues arising in the context of multinational and international distributions and sales of securities.

II. INTERNATIONAL FINANCIAL MARKETS

A. INTRODUCTION

The international financial markets 1/ are vast and complex. They have been characterized as being comprised of many elements, including the Eurosecurities markets; 2/ the foreign securities markets; 3/ the Eurocurrency markets; 4/ the

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1/ These markets are also referred to by some authors as the international securities markets. They are divided into two categories: international money markets, which include short-term instruments, and international capital markets, which include medium- and long-term instruments. These generic terms encompass many subcategories which are used herein to describe more precisely the subject of consideration. *See* Glossary.

2/ Although previously limited to the Eurobond market, this term now includes the recently developing Euroequity market. The prefix "Euro-" is somewhat of a misnomer today. Originally, the market was centered in London and existed throughout Europe. In recent years, however, with the advent of financial deregulation worldwide, the Euromarkets have greatly exceeded their original boundaries, have no national boundaries and are used by borrowers and lenders on a worldwide basis.

3/ This term is used to refer to the various domestic markets in which securities are issued by foreign entities. While Eurosecurities issues are sold internationally by an international syndicate of underwriters, foreign securities offerings are usually denominated in the domestic currency of the country where issued, and are sold primarily within that country by a domestic syndicate. With the advent of financial deregulation, however, these distinctions are becoming increasingly blurred.

foreign exchange markets; 5/ the international financial futures markets; and the syndicated bank credit markets. 6/ While this report is concerned primarily with the Eurosecurities markets, background analysis is made of the Eurocurrency markets since they provide the capital for much of the activity in the securities markets.

1. Scope of Discussion

The discussion begins with a description of the growth and development of the Eurocurrency market. The Eurocurrency market was originally dominated by the dollar sector, commonly referred to as the Eurodollar currency market. These offshore deposits of United States dollars were fueled in the 1960s by several regulatory developments in the United States, as well as by subsequent significant economic developments around the world. The description of the Eurocurrency market is followed

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4/ This is the market for deposit liabilities, denominated in a currency other than that of the country of the bank in which the deposit is made.

5/ This is the international market in which foreign currencies are traded. Transactions in foreign exchange include those in the spot, forward, swap, option and futures markets.

6/ *See generally* Credit Suisse First Boston Ltd., "The International Capital Markets" (1983) (hereinafter cited as "Credit Suisse").

by a discussion of the international short-term securities markets, referred to as the international money markets.

The international money markets are generally described as including securities issued with a duration of one year or less, as well as loans and other instruments that may not be considered securities. Included in this part of the discussion are descriptions of Eurocommercial paper, which is similar in many respects to United States commercial paper, and Euronote facilities, which provide medium-term financing commitments to borrowers, yet have many of the desired features of short-term borrowing.

A discussion of the international capital markets describes those securities and financing commitments other than Euronote facilities which have a maturity of over one year. The section begins with a historical perspective, focusing first on the development of the Eurobond market, then following its growth and expansion both geographically and in terms of products available therein. Marketing procedures and problems generally applicable to all types of issues of Eurosecurities are described, and disclosure and investor protection concerns are noted. A description of the developing Euroequity market is also included.

Finally, there is a discussion of several of the legal concerns involved in the international or multinational issuance of securities by United States and foreign entities. It is noted that the tax laws as well as the securities laws

have a large impact on the terms and conditions of the issuance of these securities. Relevant considerations are pointed out, but discussion of alternatives for resolution of problems now confronting participants in the international markets is deferred to Part VI of this chapter.

2. Introduction to the International Financial Markets

The rise of the international financial markets has been aided by several unrelated historical events. First, the rise of the multinational corporation has increased the need for access to broader capital markets and different forms of currencies. The abolition in the early 1970s of fixed exchange rates has prompted the development of such instruments as currency futures, options and swaps. Similarly, the inflation-generated volatile interest rates of the late 1970s and early 1980s have led to the creation of interest rate futures and swaps. Domestic financial deregulation and the resultant increase in the volume of cross-border capital flows has also contributed to the growth of the international financial markets. Finally, technology advances have greatly facilitated the integration of domestic and international markets.

Because of their enormous size and trading volume, the international markets play a major role in the international flow of capital and have great political, as well as economic,

significance. 7/ Borrowers as well as investors have turned to the international markets because of their enormous flexibility, which derives largely from the absence or comparative lack of regulation. Investors are attracted by the large potential marketplace and the wide range of investment vehicles, as well as the anonymity of bearer instruments and freedom from withholding taxes. Other incentives to invest in the international markets are diversification and superior rates of return.

Superior rates of return have been achieved in many foreign equities (as compared to United States equities) since many areas of the world are experiencing higher rates of investment spending and productivity growth than the United States. The primary reason for investing in international bonds, on the other hand, may lie in the array of opportunities and risks provided by the constant shifting of international exchange rate and interest rate relationships. 8/ Portfolio managers seek to capitalize on these shifting patterns and relationships which may provide more investment opportunities

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7/ See generally Fisher, International Bonds (1981) (hereinafter cited as "Fisher").

8/ See Fabozzi & Pollack, The Handbook of Fixed Income Securities (1983) (hereinafter cited as "Fabozzi"), at 637.

than might be available in any single, homogenous domestic market. 9/

International securities of all types may be found to have many similar characteristics, some of which are essential to their marketability. By definition, they are issued in markets other than the domestic market of the borrower. Debt instruments are typically unsecured, although some secured international bonds are issued. Most publicly offered international securities issues are listed on one or more stock exchanges, but are traded almost exclusively in an international over-the-counter market. 10/ Characteristics essential to their marketability include the facts that interest payments are made free of withholding tax at the source, and that the vast majority of equity and debt securities are issued in bearer form.

9/ *Id.,* at 638-43.

10/ This market was originally provided by consortium groups supported by leading European banks. An example of classic cartels, these groups ultimately failed due to the members' own failure to trade exclusively through the groups. *See* Kerr, *History of the Eurobond Market* (1984) (hereinafter cited as "Kerr"). The market today is supported by many market makers, providing deep liquidity in most issues.

B. THE INTERNATIONAL MONEY MARKETS

1. The Eurocurrency Market

The Eurocurrency market exists because of the need for financial intermediation. 11/ United States dollars are by far the most frequently used currency in this market; thus it is often referred to generically (and inaccurately to the extent of all other currency deposits) as the Eurodollar market. 12/ The following discussion focuses on the Eurodollar market; however, it should be noted that the description of that market is similarly applicable to the markets for other major currencies. 13/

11/ International banks are the intermediaries in the system, providing a conduit through which dollars and other currencies may flow from depositors to borrowers.

12/ The size of the Eurocurrency market has grown considerably over the past several years, and as of March 1986 stood at $2,964 billion. This figure represents an increase from $2,386 billion at the end of 1984, and $1,954 billion at the end of 1981. Eurodollar deposits currently represent about 73 percent of the total Eurocurrency market.

13/ It should also be noted that the prefix "Euro-" is an anachronism since foreign currency deposits are not restricted geographically to European banks. Prior to 1968, most of the Eurocurrency market was in fact centered in London. In that year, however, Singapore lifted its withholding tax on interest payments to non-residents, marking the beginning of that city's progression into an important financial center and a

(continued . . .)

Eurodollars are deposit liabilities, denominated in United States dollars, of banks located outside the United States, even if the bank is affiliated with a bank whose home office is located within the United States. 14/ Anyone can own a Eurodollar deposit, although such deposits are normally large, involving at least the equivalent of $500,000. 15/ The deposits differ from demand deposits in the United States in that they are time deposits on which interest is paid.

Eurodollars are created when a dollar deposit is transferred from a bank within the United States to a bank outside the country, or when someone outside the United States acquires dollars (e.g.- in a commercial or foreign exchange transaction) and deposits them in a bank located outside the

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(. . . continued)
leading foreign exchange market in the Pacific Basin. Reflecting the geographical separation of the Pacific market from Europe, often the terms "Asiacurrency" or "Asiadollar" are used to describe deposits of foreign currencies in Singapore or other Pacific area international banks.

14/ See discussion in Goodfriend, "Eurodollars," reprinted in Cook & Summers, Instruments of the Money Market (5th ed., 1981) (hereinafter cited as "Goodfriend"), at 123.

15/ See discussion in Eiteman, "International Capital Markets," in Roussakis, International Banking: Principles and Practices (1983), at 60-66.

United States. <u>16</u>/ In Eurodollar transactions, no dollars actually leave the United States banking system. Rather, foreign banks that accept for deposit and create loans of Eurodollars merely instruct an international bank in the United States at which they have a clearing account to make certain transfers for the credit or debit of described persons. Because hard currency transfers do not occur in the Eurodollar market, the supply of dollars within the United States remains the same, although the size of the Eurodollar market may vary widely depending on deposits made in foreign banks. <u>17</u>/

<u>16</u>/ For a more detailed description of the mechanics involved in the creation of Eurodollars, <u>see</u> Eiteman & Stonehill, <u>Multinational Business Finance</u> (4th ed. 1986), at 387-95.

<u>17</u>/ In this connection, it can also be observed that interest rate changes within the United States will always dictate changes in the Eurodollar market, and the converse will never be true. This is illustrated as follows: If the Eurodollar interest rates rose independently, this would cause the volume of Eurodollar deposits to rise. However, the volume of dollars in the United States banking system always remains the same, so a larger spread would result between the United States and Euromarket rates. An oversupply of Eurodollar deposits would then develop since the foreign banks could not loan the dollars competitively, causing the interest rate to return to the original position. On the other hand, if the United States interest rates went up, dollar deposits would flow into the United States banking system, causing the Eurodollar market to shrink, resulting in an interest rate rise in that market.

2. Regulatory Impacts on the Development Of the Eurocurrency Markets

The emergence and rapid growth of the Eurodollar market in the 1960s as a competitor to traditional foreign-exchange banking can be attributed to the regulations placed over on-shore banking operations and the corresponding absence of regulation of off-shore banking centers. 18/ The original rise of London as the center for Eurocurrency dealings was probably due to its historical financial expertise and the widespread use of the pound sterling as an international currency. However, its continued dominance of the market in the face of the recent decline of the United Kingdom's importance in world trade and the corresponding decline in the use of sterling for finance has probably been due to the significant absence of regulation by the United Kingdom of offshore transactions in foreign currencies. 19/

The Eurodollar market has continued to flourish largely due to the absence of certain types of regulation over the banks that participate. In most countries where banks are active in the Eurodollar market, there are no requirements to

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18/ *See generally* McKinnon, "The Eurocurrency Market," *in* Princeton University, *Essays in International Finance* (No. 125, Dec. 1977).

19/ *Id.,* at 6-7.

maintain non-interest bearing reserves, no government-mandated insurance requirements and few, if any, artificially imposed interest rate restrictions. Should a local government impose such requirements or regulations, the market would merely shift to another country.

Although there is usually a higher rate of return on Eurodollar deposits than on United States dollar deposits, there is also a perceived risk differential, commonly referred to as the "London premium." This risk involves the lack of insurance coverage on the deposits and the absence of a national central bank standing expressly behind the banks to provide liquidity in a crisis. Another element of the London premium involves perceived political risks. 20/

Regulatory restraints on the United States banking community during the 1960s involving restrictions on the flow of both long-term and short-term capital and interest ceilings greatly increased the growth of the Eurodollar market. 21/ Capital controls within the United States forced corporations in this country to go into the Euromarket to borrow funds,

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20/ *See* Goodfriend, *supra* n.10, at 128-32.

21/ These included the Interest Equalization Tax of 1964, retroactive to 1963; limitations imposed in 1965 on acquisition of foreign assets by United States commercial banks; the requirement in 1968 that United States multinational corporations raise funds outside the United States for new direct foreign investment; and the interest rate ceilings imposed by old Regulation Q.

largely for investment abroad. 22/ While these restraints now have been largely removed, the Euromarket is well-established, and remaining regulations, such as reserve and insurance requirements, are sufficient to perpetuate the demand for Eurodollars.

The continued existence and vitality of the Eurodollar market has provided the impetus for the development of the Eurobond market as well. Part of the reason for this is the availability outside the United States of sufficient dollars to supply a considerable demand by borrowers. Thus, borrowers wishing to avoid United States regulatory barriers but desiring to obtain United States dollars rather than another currency may issue bonds in the Euromarket. This allows borrowers to avail themselves of the huge pools of dollars that exist outside the regulatory control of the United States and is an important reason for the proliferation of the Eurobond market today.

While no fundamental changes in the regulation of the Eurodollar market appear imminent, a debate has taken place recently over whether some regulation is appropriate. There are three basic issues underlying this debate. The first issue concerns whether the Eurocurrency market has contributed to

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22/ The viewpoint in the United States at that time was that the balance of payments deficit required funds to be raised abroad for direct foreign investment purposes rather than permitting the use of scarce domestic capital resources.

worldwide inflation by complicating monetary control and providing a too ready source of capital. The second issue involves whether the Eurocurrency markets have contributed to exchange rate instability. Finally, there is a question of the degree of safety of the system of Eurobanking operations. 23/

3. Today's International Money Markets

a. Eurocommercial Paper

The advent of the Eurocommercial paper market is a recent occurrence, unlike the United States commercial paper market, which has been in existence since the 19th century. 24/ Commercial paper is short-term, unsecured debt issued in the

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23/ For a discussion of these and other regulatory issues, see Frydl, "The Debate over Regulating the Eurocurrency Markets," 1979-80 FRBNY Quarterly Review 11 (Winter 1979-80); Greenburg, "The Eurodollar Market: The Case for Disclosure," 71 Cal. L. Rev. 1492 (1983).

24/ The Eurocommercial paper market is, like its counterpart in the United States, a market for short-term unsecured debt instruments issued by large, well-known corporations. The market provides an alternative financing vehicle in the Euromarket to short-term bank loans. Eurocommercial paper is usually sold at a discount to large institutional investors, but the market differs from the United States domestic commercial paper market in that it is much smaller due to its recent development.

form of promissory notes. 25/ The sale of commercial paper is basically a substitute for short-term bank loans, and was originally necessary in the United States due to restrictions that prevented banks from providing services in more than one state. The advent of consumer finance companies at the beginning of this century also contributed to the growth of the

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25/ Most of this paper is of 270 days duration or less. Longer term commercial paper must be registered with the Commission since it is not exempt under Securities Act section 3(a)(3). Most domestic and Eurocommercial paper is issued under the section 3(a)(3) exemption, although section 4(2) has also been used for issues of commercial paper that either have maturities exceeding statutory requirements or have other characteristics that would cause them to fall without the parameters of section 3(a)(3) (*e.g.*, notes not intended for use to finance current transactions).

Commercial paper is sold on the open market, either in interest bearing form or, more frequently, on a discounted basis. As of 1985, more than 1,300 companies in the United States were issuers of commercial paper, with financial companies comprising more than 70 percent of the market. Federal Reserve Bank of New York, *Commercial Paper* (1985), at 1. Commercial paper is distributed through dealers or directly through finance companies. Industrial companies and some consumer finance companies use dealers to place their commercial paper with investors. A very competitive marketplace and resultant small spreads dictate that commercial paper be sold only in large increments, usually no smaller than $250,000. Smaller increments may be found in the direct commercial paper market, which is used by finance companies who are able to place their paper directly with investors. These institutions may be more willing to issue paper in smaller denominations to facilitate investment by a greater number of individual investors. Further, the usual dealer spread of about 1/8 of a percentage point, or $125,000 on every $100 million placed, can be saved through direct issuance.

United States commercial paper market because of the need for capital to lend directly to consumers. In the past forty years, the long upward trend in interest rates and the huge increases in sales of financed consumer goods have caused a great expansion in the United States commercial paper market. 26/

Prior to the early 1970s (and to a large extent throughout the 1970s and early 1980s), the United States market was used to satisfy the commercial paper needs of both United States and foreign private and sovereign issuers. The first Eurocommercial paper issue, by the Aluminium Company of America, was brought to market in 1970 by the predecessor of Credit Suisse First Boston Limited. 27/ The idea did not encounter widespread acceptance by European issuers, however, and the market became inactive until the early 1980s. Several United States issuers returned to the market in 1980, and in 1981 the first non-United States issuer, the Marubeni Corporation, entered the Eurocommercial paper market.

This market has risen rapidly over the past five years, with further increases anticipated. One reason for the rise of the Eurocommercial paper market may be the advent of flexible

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26/ For a discussion of the history and development of this market, as well as issuing techniques and investment considerations, see Fabozzi, supra n.7, at 232-42.

27/ See Credit Suisse, supra n.4.

framework agreements that allow an issuer to request immediate sale by a dealer, or under which a dealer may take advantage of a market window by requesting the issuer to sell paper. Another factor in the growth of the Eurocommercial paper market has been the rise in telecommunications capabilities, which has created a marketplace in which every minute is crucial. Thus, in a market where timing is of utmost importance, the fact that the European markets open sooner in the day than the United States markets has contributed to the growth of the Eurocommercial paper market.

The use of Eurocommercial paper by blue chip issuers has become an attractive alternative to bank borrowing recently due to the development of the Eurocommercial paper market. The borrowing rate is usually set at a small margin above that for bank money market securities of similar maturities (which in turn is slightly less than the London interbank market and the United States commercial bank market). It is also desirable as a means for diversification of an issuer's source of funds.

Unofficial figures 28/ set the value of today's United States commercial paper market at $253 billion outstanding, as compared with the $58 billion value of Eurocommercial paper

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28/ These figures were supplied by panel speakers at the Biennial Conference of the International Bar Association, Section on Business Law, Committee on Issues and Trading in Securities, September 16, 1986, New York.

outstanding. 29/ Several differences are inherent between the United States and Eurocommercial paper markets. The United States borrowing instrument is typically a simple promissory note, usually governed by New York law. The notes issued in Eurocommercial paper financings are more complex. United States commercial paper is usually backed by a letter of credit or other guarantee, while the European counterpart has no such credit enhancement. In order to achieve market acceptance in the United States, it is necessary that issuers of commercial paper have an investment grade rating by one or more rating agencies. 30/ This has not been a requirement in the Eurocommercial paper market, however, possibly due to the lack of comparable rating agencies in most other countries. 31/

29/ Investors in the Eurocommercial paper market include private pension funds, money market mutual funds, governmental units, bank trust departments, foreign banks and investment companies.

30/ The following five organizations currently rate commercial paper: Standard and Poor's, Inc. and Moody's Investor's Services each rate more than 1,300 issuers; McCarthy, Crisanti, Maffei, Inc. rates more than 500 issuers; Fitch Investor Services Corp. rates more than 240 issuers; and Duff and Phelps, Inc. rates more than 100 issuers.

31/ This distinction can cause a marketing problem for some United States investors. For example, many United States institutional investors are restricted in their securities purchases or investments to instruments that are of a certain investment quality. For a discussion of EuroRatings, the new London-based European rating agency that has recently commenced operations with the issuance of ratings on short- and

(continued . . .)

Nevertheless, there are currently about six United Kingdom issuers that have been rated by Moody's. 32/ Other distinctions between the two markets involve different lengths of maturities 33/ and the forms in which the securities are issued. 34/ Finally, United States commercial paper issues typically are done on a firm underwriting commitment basis,

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(. . . continued)
long-term debt of 45 foreign issuers, see Part IV.B.8., infra. See also individual country chapters for discussions of their domestic rating agencies.

32/ There is some reluctance by European issuers to submit to the rating process by United States credit agencies. For instance, there would be considerable embarrassment if the company did not receive the rating that it desired or expected. Further, the rating agencies look closely at many aspects of the business of the issuer, including its liquidity, and the procurement of a rating involves certain fixed costs. Since one of the principal reasons for issuing commercial paper in the Euromarket is cost, the additional fees involved in obtaining a rating may affect the decision to enter this market.

33/ United States commercial paper maturities vary over a broad range, from 25 to 270 days. Eurocommercial paper is usually issued in maturities of six months. Issues of Eurocommercial paper by United States companies are limited to maturities of 183 days or less in order to take advantage of the exemption from United States withholding tax for certain short-term discount obligations.

34/ United States commercial paper is usually issued in physical form, while Eurocommercial paper is increasingly being issued in paperless form, with most trades cleared on the books of one of the clearing agencies set up to service the Euromarket.

while Eurocommercial paper offerings are usually brought to market on a best-efforts basis.

b. Euronotes: Innovative Medium Term Finance

The recent development of medium-term Euronote issuing facilities 35/ demonstrates the scope of financial innovation that this largely unregulated market continues to experience. In order to understand the need for these note facilities, it is useful to refer briefly to the sources of medium-term credit utilized over the past two decades.

In the 1970s, short- and medium-term credit facilities were provided almost exclusively in the Euromarket through Eurocredits. Eurocredits are lending facilities set up by bank syndicates that can be drawn upon under certain circumstances by the borrowers. Problem loans that surfaced late in the

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35/ Euronote facilities take many forms, as discussed in this section, but can be characterized generally as a method whereby companies arrange to sell short-term notes (comparable to commercial paper) from time to time in international markets. The facilities provide that the notes will be purchased by the underwriters in the event that they cannot be successfully placed with investors. Such facilities entail two types of risk, borne separately by the underwriters and the company. Risk of market fluctuations is borne by the underwriters since they ensure that the notes will be purchased, while risks specific to the issuer are borne by the issuer since the underwriters are promised that the agreement may be avoided in the case of an adverse event affecting the issuer's credit.

1970s and early in the 1980s caused such bank syndicates to acquire a profound distaste for such facilities and the detrimental effect they had on balance sheets. Thus, the Eurocredit of the 1970s slowly became replaced by new financing instruments that are commonly used in the 1980s. These new instruments include floating rate notes (FRNs) for long-term capitalization, Euronotes for medium-term debt, 36/ and Eurocommercial paper for short-term liquidity.

Euronote facilities are designed to blend the short-term nature of Eurocommercial paper with the need of borrowers for medium-term financing commitments. In fact, there are very few differences in the notes issued under a Euronote facility and Eurocommercial paper, other than that the former are issued pursuant to an agreement which is designed to keep available a certain amount of the issuer's paper for a stated period of time (medium-term). 37/ Euronote facilities may be provided on either an "end-to-end" or "revolving" basis. In the former case, a set amount of notes is constantly outstanding

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36/ For a comprehensive discussion of today's Euronote market, *see* Bankson & Lee, *Euronotes* (1985).

37/ Other differences are a result of the fees charged to establish and maintain the facility and the corresponding slightly higher interest rate that must be charged. Fees charged include the facility fee (usually 3-15 basis points), a utilization fee (5-10 basis points), a management fee (5-15 basis points), and a variable commitment fee for unused portions of the facility.

throughout the term of the facility, and is merely rolled over by the underwriters. A revolving facility, by contrast, has a maximum amount that may be drawn down by the issuer at its convenience, and the amount outstanding may vary significantly over the term of the facility. 38/ Such facilities are attractive to banks since the obligation to place notes is not reflected on their balance sheets. 39/

The intense competition in this market has led to a proliferation of names and types of Euronote facilities. The two most well-known are the RUF and the NIF. A RUF, or revolving underwriting facility, combines an arrangement for issuing short-term notes with a medium-term commitment from a group of international banks to purchase the notes if they are not sold immediately to investors. The acronym NIF, which stands for note issuance facility, identifies a facility similar to a RUF, but may be used to describe a situation where

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38/ The Euronote facility is usually an arrangement among the issuer, the arranger or manager of the facility, and the group of banks that provides the commitment to purchase the notes. A more detailed description of the roles of the various parties may be found in Whitman, "Short-Term Euronote Facilities, Revolving Underwriting Facilities, and Euro Commercial Paper," *in* Practising Law Institute, *Current Corporate Financing Techniques* (1986) (hereinafter cited as "Whitman"), at 301-02.

39/ Since these facilities are contingent contractual duties, they are not classified as assets, which must be recorded on banks' balance sheets.

only a best-efforts type commitment is made to the borrower. 40/ Other acronyms have been given to Euronote facilities in an attempt to distinguish them for marketing purposes. 41/

Euronote facilities may be underwritten through a sole placing agent or through what is known as a "tender panel" facility. In the case of the former, if the placing agent is unable to sell the paper in the market, the underwriting banks must each purchase a portion of the issue at the facility price. This arrangement was unsatisfactory to many banks; thus, the tender panel was created, whereby the underwriters may bid for notes of the issuer upon its request. The issuer can then accept the bids in order of the lower yields.

Purchasers of Euronotes tend to be sophisticated investors

40/ Whitman, supra n.37, at 287.

41/ An illustrative, but certainly not exhaustive, list includes the following: TRUF, or transferable revolving underwriting facility (provisions for relatively easy transfer of rights and obligations under the facility); PUF, or prime underwriting facility (based on the United States prime rate instead of the usual LIBOR, for less credit-worthy borrowers); SNIF, or syndicated (or standby) note issuance facility; MOF, or multiple option facility (providing for financing of several types, e.g.- commercial paper, bankers' acceptances, etc.); and GNF, or global note facility (allows issuance of commercial paper in both Euro- and United States markets according to windows of opportunity).

who desire the liquidity of money market instruments. 42/ The credit-worthiness of the issuers will dictate the interest rates available to them, which in turn will attract different types of investors. Less developed countries and smaller, lesser known companies will generally obtain credit in the LIBOR+ range, 43/ attracting commercial banks as investors. Developed countries may issue notes bearing interest in the LIBID 44/ range (or even below LIBID), attracting large institutions and pension funds as investors. A LIMID 45/ range is usually available to multinational corporations, and a broad range of investors including those listed above have exhibited an interest in these notes.

An information memorandum is used as the disclosure and selling document for Euronotes issued pursuant to a note issuance facility. The memorandum has derived some of its characteristics from documents used in international syndicated loans, United States commercial paper offerings, and typical

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42/ There is an active secondary market in Eurocommercial paper and Euronotes, even though many investors hold the notes to maturity.

43/ London interbank offered rate. LIBOR is the deposit rate applicable to interbank loans within London.

44/ The term refers to the London interbank bid rate.

45/ The term refers to the mid-range of the spread between LIBID and LIBOR.

Eurobond issues. However, the format has been structured to address the lengthy commitment period, the continuous offering nature of the facilities, and the sophistication of the potential investors. Thus, the information memorandum typically contains two parts: first, "facility specific" material which describes the terms of the particular issue; and second, a description of the borrower, usually including (or incorporating by reference) the most recent annual audited financial statements and all subsequent interim or special reports. 46/

c. Other Products

Other money market instruments are gradually being used more frequently in the Euromarket. 47/ Among these are certificates of deposit ("CDs"), which were first introduced to the Euromarket in the early 1960s by leading United States commercial banks. An active secondary market has developed for CDs issued in the Euromarket. While United States banks are subject to reserve and other regulatory restrictions, their European branches and foreign competitors are not. Thus, more

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46/ See Whitman, supra n.37, at 306-07.

47/ See generally Fabozzi, supra n.7, at 665-70.

favorable rates may be obtained in the Euromarket for these instruments.

Some London banks have begun to issue CDs denominated in pounds sterling. CDs have also been issued in floating rate form, with the applicable interest rate keyed to LIBOR or, in the case of Asian-dollar CDs, the Singapore Interbank Offered Rate (SIBOR). 48/

Another type of money market instrument available in the Euromarket is the bankers' acceptance. This is a draft for payment of United States dollars by a United States bank that has been accepted by that bank. Such bills are traded actively in a secondary market on a discount basis and are not subject to United States withholding tax. In London, these instruments are called banks bills, and are highly liquid instruments. 49/

48/ SIBOR is the deposit rate applicable to interbank loans in Singapore.

49/ *Id.*, at 666-67.

C. THE INTERNATIONAL CAPITAL MARKETS 50/

1. Historical Perspective

The largely unregulated international capital markets provide mechanisms through which individuals and non-banking institutions are able to participate in highly diversified financial investment vehicles. The fiercely competitive nature of this market has fostered the proliferation of financial products and techniques never before utilized in traditional domestic markets.

The beginning of the Eurobond market can be traced back to 1963, to an issue by Autostrade. 51/ The year 1963 is significant also for United States issuers because that was the retroactive effective date of the Interest Equalization Tax of

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50/ The term "international capital markets" includes both domestic issues of securities by foreign companies in the domestic currency (foreign bonds) as well as multinational offerings not necessarily denominated in the currency of any of the countries involved (Eurobonds). Only the latter type of security will be discussed herein. *See* discussion at notes 1-3, *supra.*

51/ Autostrade is the operator of toll roadways in Italy. The issue was guaranteed by IRI, a state-owned holding company. The lead manager of the $15 million, 15-year financing was a London bank, while the co-management group included banks in Belgium, West Germany, the Netherlands and Luxembourg. *See* Fisher, *supra* n.6, at 19-20; Kerr, *supra* n.5, at 11-16.

1964 (the "IET"). 52/ The IET was the Kennedy administration's response to the perceived contribution of foreign issues of securities in the United States market to the United States' balance of payments deficit that existed at that time. Foreign issues were typically offered at a more attractive interest rate than domestic issues, resulting in a large capital outflow. The IET was designed to effectively reduce the yield on foreign securities to United States investors, thereby making them less attractive. Imposition of this tax caused foreign borrowers to turn to foreign markets to obtain capital. The huge pool of dollars contained in Eurodollar deposits in international banks was the best available source for dollars outside the United States, and the Eurobond market developed in order to take advantage of this capital base.

Although the IET did not cure the United States' balance of payments problem, it had the collateral effect of encouraging the reopening and development of European capital markets. The entry of United States corporations into the Euromarket accelerated in 1965 with the imposition of voluntary restraints on capital formation by multinational corporations.

52/ The IET imposed a tax on issues by foreign entities of securities in the United States. The idea of "equalization" derives from the fact that prior to the tax, issuers of foreign securities in the United States could offer a higher yield on the securities than could comparable United States issuers due to interest rate differentials between the United States and foreign markets.

The voluntary restraints promoted capital formation abroad by United States corporations by requiring them to finance their foreign operations from abroad. The change in 1968 in the program from voluntary to mandatory and the creation of the Office of Foreign Direct Investment to administer the controls caused an immediate surge in the volume of dollar-denominated Eurobonds issued by United States corporations during the late 1960s. 53/

The mid-1970s saw several further developments in the Eurobond markets. In 1974, the IET was allowed to expire, causing speculation that the Eurobond market would soon be displaced by the United States domestic market. This never happened, however, and the Eurobond market continues to flourish. In 1977, the European Investment Bank floated the first Euroyen bond issue. Since that time, Euroyen bond issues have become increasingly important due to significant regulatory developments in both the United States and Japan that have simplified procedures for issuing Eurobonds by United States and Japanese companies. In 1984, Japan first allowed Japanese companies to issue yen-denominated bonds outside

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53/ The volume of Eurobond issues by United States companies increased from $527 million in 1967 to $1,963 million in 1968. The years during which the Mandatory Restraint Program was in effect (1968 through 1973) saw United States corporations float 271 Eurobond issues for a total of $6,978 million, or nearly 33 percent of the entire market over the period. Fisher, supra n.6, at 21.

Japan. The next year saw the removal by the Japanese government of the 20 percent withholding tax on interest paid to foreign securities holders by Japanese companies. These developments have allowed Japanese companies to access the cheaper capital that is available in the Euromarket, and to structure borrowings that are not secured, which are typical in the Euromarket but rare in Japan.

In the United States, the passage of the Tax Reform Act of 1984 ("TRA 1984") facilitated Eurobond financings by United States issuers by repealing the 30 percent withholding tax on payments of "portfolio interest" in the case of debt securities issued after July 18, 1984, to non-United States holders. 54/

The creation of central clearing houses for different types of Eurosecurities has also facilitated the growth of

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54/ Prior to that time, a convoluted structure was necessary for the issuance of Eurobonds by United States companies in order to avoid the withholding tax. The United States corporation would set up an off-shore single-purpose finance subsidiary that would issue bonds into the Euromarket. For marketing purposes, the bonds would be guaranteed as to principal and interest payments by the parent company. After closing, the subsidiary would loan the proceeds of the offering to the parent. The interest payments by the parent to the subsidiary would not be subject to withholding tax due to a tax treaty between the United States and the offshore jurisdiction where the finance company is incorporated.

For a further discussion of Eurobond tax considerations, see Beller & Berney, "Eurobonds," 19 Rev. Sec. & Commodities Reg. 39 (1986); discussion at Part C.5.a., "Tax Law Considerations," infra.

markets for those securities. Originally established to provide for easy clearing, storage and transfer of Eurobonds, Euro-clear 55/ and Cedel 56/ have evolved into international clearing houses for many types of securities. These institutions are subject to the regulations of the Association of International Bond Dealers, a self-regulatory organization of international importance.

2. Bringing a Eurobond Deal to Market: Procedural Aspects

a. Marketing Considerations

Two distinguishing characteristics of most Eurobonds are that they are issued in bearer form and interest is paid free of withholding taxes. Recently, the former requirement has been eroded because institutional purchasers are replacing individual investors in the Eurobond market, and institutions do not have the same perceived need for anonymity as do wealthy

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55/ Established in Brussels in 1968 by Morgan Guaranty Trust Co., Euro-clear is owned by a large number of mostly European and North American banks. *See* Kerr, *supra* n.5, at 98-100.

56/ Established in Luxembourg in 1971 to provide competition for Euro-clear, Cedel is owned by a large group of European banks.

individual purchasers. 57/ The Eurobond market can be characterized as a "name market," i.e., well-known issuers from developed countries dominate the market, which is by its nature very conservative. 58/ International banks that bring these issuers to market are reluctant to underwrite securities of financially nominal or lesser-known issuers, because they will suffer harm to their reputation that may affect their ability to obtain future business if problems surface with the deals. 59/ Other essential factors that may affect a company's

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57/ The greatly increased role of institutional investors in the United States domestic market has been mirrored in the Euromarket. Among the most active institutional investors in the Euromarket today are such entities as central banks, especially of oil-producing countries which have accumulated enormous reserves over the past decade (so-called "petrodollars"). Other categories of institutional investors include government agencies and international organizations, pension funds, insurance funds, investment companies and trusts, corporations and bank trust departments. See, e.g., Fisher, supra n.6, at 31-32.

58/ Since foreign issuers are generally not rated by United States credit agencies, the names and reputations of both the borrower and the underwriters are very important to the marketability of the issue.

59/ This is not to say that such issuers are not brought to market. Relatively smaller banks may be more willing to underwrite lesser-known issuers' securities in an effort to develop a client base and exhibit placing capability, both of which will help them edge into the underwriting groups for the better-known issuers, which will typically be led by the largest banks.

acceptance in the marketplace are its size and past issuing frequency.

The lack of a disproportionate number of failures in this market as compared to more regulated markets may be attributed to several factors, including the reluctance of banks to do business with lesser-known or smaller companies. 60/ In recent Congressional hearings, several industry leaders commented that despite large regulatory differences between the United States market and the Eurobond market, there have been no significant failures of financial institutions in the Eurobond market. 61/

As a result of the intense competition in the Euromarket, many product innovations recently have been introduced. By far

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60/ Generally, United States companies rated below the level of single A have difficulty arranging financing in the Euromarket. Thus, new and emerging ventures have very restricted access to the market, and in any event, the participation of a major bank in a deal is essential to its acceptance by the market. *See* Von Clemm, "United States Companies Raising Capital Abroad," 1981 J. Comp. Corp. L. & Sec. Reg. 122, at 129.

61/ *See* *The Internationalization of Capital Markets: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs,* 99th Cong., 2d Sess. (1986) (responses to written questions from Senator Garn). The impression of the participants was that such differences had no impact on financial institution failures due in part to their professional nature. Although there have been international financial institution failures, these have been a result of reasons other than their participation in the Eurobond market. *Id.,* at 150, 161, 205, and 228. *But see* discussion regarding Investor Overseas Services *in* Kerr, *supra* n.5, at 32-34.

the most successful new product has been the floating rate note ("FRN "). 62/ These are particularly attractive to institutional investors today, since interest rates are keyed to LIBOR. FRNs now constitute at least a third of all issues done in the Eurobond market. The coupon in these issues is reset every three to six months, subject to a set minimum. FRNs have now been coupled with other innovative features such as put options and procedures whereby the rate may become fixed for the remaining maturity of the note. 63/

Examples of other recent innovative products are oil-indexed bonds, zero coupon bonds, deferred coupon bonds, warrants, extendible notes, multi-currency instruments and deep discount bonds. Foreign currency denominated bonds have become popular with United States issuers over the past few years. These bonds provide an opportunity for arbitrage in the foreign exchange markets. This opportunity, when coupled with the development of the huge currency swap market, decreases the

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62/ FRNs were actually created in 1970 with an issue by Ente Nazionale per l'Energia Ellectrica (ENEL), the government-owned Italian power company; however, their use has greatly increased recently, especially with banks as issuers. For an interesting discussion of claims by several individuals to first having the idea of creating floating rate notes, see Kerr, supra n.5, at 36-38.

63/ The 1979 issue by TVO Power Company was called a Floating Rate Drop-Lock. This set a minimum beyond which the rate could not descend, and provided that if the rate actually reached this point, it would be locked into that rate until maturity.

costs of borrowing in the Eurobond market. There are basically two types of foreign currency denominated bonds used: the single currency or the dual currency. One example of a dual currency offering provides that the issue price and interest are payable in a foreign currency, while the principal is payable in another. 64/

b. Organization and Timing

The structure of the typical Eurobond syndicate 65/ is somewhat different from that commonly used in the United States in that it encompasses three tiers as opposed to the two-tier

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64/ Recent issues have been floated by Student Loan Marketing Association and Federal National Mortgage Association, both in yen and dollars.

65/ The Eurobond syndicate framework typically is the same as that commonly utilized in the United Kingdom. *See* discussion in Part IV, *infra.* United Kingdom merchant banks, together with United States investment banks, led the field in the 1960s, joined in the 1970s by large Swiss and German banks. The Japanese have made significant inroads into the Euromarket underwriting business in the 1980s. Creative issuing techniques are also being introduced. These include the "bought deal," which seeks to avoid the negative effects of the grey market discussed *infra* at n.67. In the bought deal, one or two banks buy the entire issue from the borrower, then try to place it immediately in the market. Naturally, such banks must have significant capital reserves to accommodate this type of commitment, and substantial market risks are involved.

arrangements found in this country. 66/ The first tier consists of the management group, the second includes the underwriters, and in the third tier are found the selling group members. The managers are usually contractually committed to purchase the entire issue from the borrower, while the underwriters are contractually committed to purchase certain portions of the issue from the lead managers. In the United States, typically the underwriters are all committed to purchase the issue from the borrower. Selling group members purchase their allotted portions of the offering directly from the managers in the Eurobond issue, as opposed to purchasing from the underwriters in the United States issue.

There are several significant days that occur in the process of bringing an issue of Eurobonds to market. The first is the announcement day, which usually takes place a week or two before the actual offering commences. At the announcement, the issuer, amount, maturity and coupon of the projected issue are announced. Following the announcement day, and prior to the offering day, is the subscription or offering period. It is during this time that the selling group is formed and underwriting commitments are finalized. 67/ Preliminary

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66/ *See* discussion in Part III, *infra.*

67/ During this time there is generated a so-called "grey market" in the securities. This market is a sort of "when-issued" market, and can have a significant effect on the price of the issue. Prohibited by (continued . . .)

offering documents, consisting either of a prospectus or offering circular, are distributed at this time. Also during the subscription period the issuer applies to an appropriate exchange for listing.

The next significant event is the pricing of the issue. Since the maturity and coupon have already been announced, the market has had time to respond to the terms of the issue. This results in a determination by the lead managers of the appropriate issue price on the day (or night before) the offering commences. After the offering agreement has been signed, allotment telexes are sent to the various underwriters and selling group members indicating their individual portions of the offering. Closing of the deal, including payment to the

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(. . . continued)
United States securities laws in this country, the grey market occurs in connection with Eurobond issues when members of the selling group and underwriters are subjected to pressure from purchasing institutions to supply the issue at discount rates prior to the actual offering date. This can be done by estimation of the actual offering price and subtraction from that of some or even all of the underwriting and selling commissions to be received. Naturally, such practices cause downward pressure on the ultimate issue price, and lead managers do not look favorably on underwriters or selling group members discovered to be participating. For further discussion of the grey market and its implications, _see_ Fisher, _supra_ n.6, at 80-82. Nevertheless, the grey market has become an accepted part of the Euromarket today, and arguably performs an important function in pricing efficiency. _See_ Kerr, _supra_ n.5, at 56-57, 88-89.

issuer of the funds generated thereby, usually occurs within two weeks of the offering day.

3. Disclosure and Investor Protection

One reason commonly cited for the growth of the Eurobond market is the lack of direct regulation over it by any national government, which allows an environment of free competition. Despite this unregulated atmosphere, disclosure is provided according to market requirements, and the lack of uniform disclosure guidelines has not resulted in a disproportionate number of defaults or failures of financial institutions in the market. Nevertheless, each participant in the Euromarket is necessarily resident in some country, and each country has some form of securities regulation which affects practices in the international marketplace. Since virtually all Eurobond and Euroequity offerings are listed on an exchange, 68/ the disclosure requirements of the country in which the exchange is located must be followed. Further, currency restrictions in most countries affect participation by their nationals in the Euromarket as well as the use of their currencies in international finance.

68/ This is done for the purpose of, among others, satisfying the needs of institutional investors who may be restricted by their domestic authorities as to the types of investments that they may acquire and hold.

Effective national disclosure requirements such as those in the United States have arguably contributed indirectly, but significantly, to the disclosure standards in the Euromarket. The existence and impact of United States regulation on the United States market, which is the largest securities market in the world, have caused the international marketplace to come to expect certain information to be provided regardless of whether it is required by law. In addition, the European Economic Community has adopted certain Directives in an effort to set forth minimum statutory requirements regarding corporations, listing requirements for exchanges and continuing disclosure. 69/ Many countries in Europe currently have domestic disclosure requirements more comprehensive than the standards set forth as minimal requirements in the Directives. However, some countries have segregated disclosure requirements for issues that are done other than simply within the domestic market. An example of this is found in the listing

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69/ *See, e.g.,* Council Directive of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing, 22 O.J. Eur. Comm. (No. L 66) 21 (1979); Council Directive of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing, 23 O.J. Eur. Comm. (No. L 100) 1 (1980); Council Directive of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing, 25 O.J. Eur. Comm. (No. L 48) 26 (1982). *See* discussion at Part IV.A., *infra.*

requirements for the International Stock Exchange. 70/ There are special provisions applicable solely to offerings in the Euromarket which, among other things, provide for less stringent disclosure requirements.

Thus, in the Euromarket, while no comprehensive, single set of rules delineates precise disclosure requirements, as a practical matter, the prospectuses and offering memoranda used to sell securities there are sufficiently detailed, in most cases, to provide all necessary information 71/ to investors. Although there have been examples of failures of this disclosure system, 72/ these are few compared to the volume of successful issues. It therefore appears that a combination of

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70/ London Stock Exchange, Admission of Securities to Listing (1980), at Section 7.

71/ The term "necessary information" is used in this context to describe the concept of that information which is required by the investor according to its demands before it will invest. This concept assumes the investor will not buy securities about which it does not have sufficient information - an assumption essential in understanding the market forces that shape conduct in the Euromarket. As noted earlier, since the Euromarket is largely a "name market", investors usually will invest in well-known issuers' securities, only straying to smaller, more obscure issuers when sufficient information can be obtained.

72/ Some say that the recent Fiat offering failed due to deficient disclosure. *See* discussion in the following section.

natural market forces, 73/ national and multinational disclosure requirements, and the influence of strong disclosure systems like that of the United States contribute to the level of disclosure now found in Euromarket offerings. This mixture of influences acts to provide the current environment in which the Euromarket now operate.

4. Euroequities

a. Fast Growing Market

The mechanisms that have for many years been utilized in the initial offering and subsequent resale of Eurobonds and other debt securities are now being mobilized for the purpose of placing shares of major corporations through an international network. This new market is called the Euroequity market. 74/ The center of this market is, as is

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73/ The growing importance of the institutional investor, the highly competitive nature of the market, and the preoccupation of banks and securities dealers with maintaining their good reputations in the market have all contributed to the pressure for adequate disclosure in the market.

74/ Actually, the term "Euroequities" has been around for much longer than the phenomenon described herein. As early as 1970, it was used to describe the growing market for shares represented by International Depositary Receipts ("IDRs"), which serve much the same function in the world's markets as do American Depositary Receipts ("ADRs") in this country. *See*

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true in the Eurobond market, in London. Nevertheless, traditional United Kingdom share offering practices are not followed in the Euroequity market. For example, price discounts and preemptive rights, commonly associated with United Kingdom domestic deals, are usually not found in Euroequity deals. The Euroequity market is still primarily a new issue market, with most of the active secondary trading in issues taking place on the home exchange of the issuer. Despite this fact, the secondary market for Euroequities is clearly growing at a fast pace, with over 500 securities traded daily outside their home market as of May 31, 1986, as compared with only about 200 the year before. 75/ Additionally, the International Stock Exchange's Automated Quotation System ("SEAQ") quotes major international securities in a trading system modeled after the National Association of Securities Dealers' Automated Quotation System ("NASDAQ"). In fact, SEAQ quoted these international shares before "Big Bang", and before the inclusion of domestic shares in the system.

The placing of equities through traditional Euromarket syndication procedures, previously nonexistent, has become

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(. . . continued)
"Surge in Bearer Shares," Barron's, June 6, 1970, at 9-10.

75/ "Euro-equity; Euromoney for old rope," Economist, May 31, 1986, at 96 (U.S. edition at 90).

commonplace in the last few years. 76/ While only a few years ago most companies raised equity capital in one or two major markets, offerings by significant companies today typically include an international tranche. 77/ This development can be attributed to the strength of the world's equity markets in general. Equity is issued internationally for several reasons. The most commonly cited of these include the desire to obtain a broader shareholder base and to realize a price more

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76/ This is not to say that international equity offerings are new. To the contrary, international equity offerings have been conducted for decades. It is only through international placements that the largest Swiss companies, for example, can raise sufficient equity to meet their needs. This is due to the relatively small capital market in that country and the limited resources of its investors. Companies from smaller countries have traditionally gone to London or other major markets to float equity in order to keep from flooding their relatively illiquid home markets and at the same time to obtain the best prices for their shares.

77/ A single offering may be divided into two or more "tranches" which contain securities of the same class or similar classes, but which may be offered in a different manner or have slightly different terms or conditions. Offerings that are primarily based in one country and also contain an international tranche may be technically excluded from the definition of Euroequity. However, to the extent that the international tranche of these issues is distributed through an international syndicate of underwriters such as is commonly associated with the Euromarket, that portion of such an offering may be considered for the purposes of analysis as a Euroequity deal. Such deals are increasingly becoming more commonplace in large offerings. By definition, a Euroequity issue would be placed entirely through an international syndicate.

representative of international market demands for the issuer's shares. A broader offering can reach more willing investors, more efficiently reflect the worldwide demand for an equity issue, and make more difficult an unwelcome takeover bid. 78/

Another factor that will contribute to the growth of the Euroequity market is the establishment by Euroclear in April 1986 of a clearing service for international equities. Soon to be expanded, the service originally encompassed some 100 equities from five European countries. 79/

The adaptation of the traditional Eurobond placement network to the Euroequity market has not been accomplished without certain problems, however. Different approaches are being utilized but no standard method has yet gained wide acceptance. It is clear, however, that the different types of

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78/ An excellent example of this approach is that utilized by W.R. Grace in its convertible Eurobond issue early this year. The bonds are convertible into equity after five years, except in the case of a certain type of change in control, in which case investors can convert into equity at a much more attractive rate. This is thought to be the first "poison pill" brought to the Euromarket. See "The Poisoned Atmosphere for International Equities," Economist, Feb. 1, 1986, at 75.

79/ The first countries' equities to be included in the service were Belgium, West Germany, Netherlands, Sweden and Switzerland. See "Five Nation 100 Share Service Launched," Financial Times, April 21, 1986, at I-40. Despite the new service, major problems exist in international equity clearing procedures. See, e.g., "International Equity Trading," Financial Times, April 21, 1987, at III-X.

investors in debt and equity must be considered in the marketing decision-making process. Recognizing these differences, recent issues have seen two broad classifications of underwriting techniques being used by large syndicate managers.

Swiss Bank Corporation International ("SBCI") used the first of these techniques in a recent offering by Transamerica Corp. In that offering, SBCI set up separate underwriting syndicates in the countries where the securities were being offered, thus dispersing the securities geographically. This method is designed to encourage firmer placement by the regional co-managers with final investors in their respective countries. Further, the manager arguably retains a more flexible control over the flow of the issue to the marketplace, since securities can be channelled to countries where there is more demand.

Another method of syndication has been popularized by Credit Suisse First Boston ("CSFB"), and involves the use of a much smaller group of co-managers in a single underwriting syndicate. This method is based on the belief that the presence of too many co-managers adds an unnecessary management layer. With the smaller group, CSFB and others using this technique try to maintain close control over the placement of the securities, and at the same time delegate less of the management responsibilities to others at the co-management level.

Typically, the type of issuer that will come to the Euroequity market is the company with an international market for its products. This preexisting name recognition factor in foreign countries has proved very important to the placement of shares, particularly in the cases of some internationally well-known United States companies whose shares were readily accepted in the market. 80/ Other typical issuers come from countries with a limited or relatively illiquid domestic capital markets. 81/

One of the largest Euroequity deals accomplished to date (before the recent Fiat deal, discussed *infra*) was the KLM Royal Dutch Airlines flotation of 15 million shares worth the equivalent of $295 million. Recently, Electrolux rivaled the KLM offering with a nine country placement of 8 million shares worth about $276 million. These 1986 issues, when compared with numbers of the three previous years, illustrate the current rapid growth of the Euroequity market. From 1983 to 1985, all Euroequity deals completed amounted to a total of the

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80/ *See* Lohr, "Turning to Europe for Equity," New York Times, Aug. 21, 1986, at D-1, col. 3; discussion accompanying notes 63 through 65, *supra.*

81/ Examples of these companies are European multinational companies such as Nestle, Volvo, Electrolux and Daimler-Benz.

equivalent of $3.2 billion. 82/ Through August 1, 1986, Euroequity issues by ten large United States issuers 83/ have totaled over $610 million, and 37 issues around the world have raised over the equivalent of $3.1 billion. 84/ In all of 1985, there were only three issuers in this market from the United States.

b. The Fiat Offering

The recent deal involving the secondary offering of Fiat shares has temporarily given the Euroequity market a setback, at least insofar as very large issues are concerned. The $2.1 billion issue was denominated in United States dollars, 85/ and executed through a blue-chip underwriting syndicate led by Deutsche Bank Capital Markets, the London affiliate of the West German bank, and Mediobanca of Italy. Ten other top

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82/ "The Dangers of Deregulation," Financial Times, May 9, 1986, at I-21.

83/ The large corporations on this list are joined by the Student Loan Marketing Association, a quasi-government agency.

84/ "Turning to Europe for Equity," supra n.84.

85/ It may be noted that this Euroequity deal differed from most deals in that the currency denomination of the shares was different from that of the shares traded on the home listing exchange.

underwriters were included in the deal as co-lead managers, and each was assigned a geographical territory in which to place its allocated shares. The problem with the issue, which is commonly laid to overpricing of the shares as well as other factors, 86/ arose when the market price of the shares, which are quoted on the Milan Stock Exchange, fell a total of $100 million the first day after the offering was commenced.

The price of the shares was set the night the offering was commenced at about a four percent discount to the closing that day in Milan. However, that price reflected a recent run-up associated with announced bright prospects for the company, and was thus subject to significant correction. In addition to the high offering price, the underwriting syndicate had no opportunity to pre-sell the issue prior to commencement of the offering. This was due to the insistence of Libya, the selling shareholder's predecessor, on complete secrecy regarding the offering until it was formally launched. Syndicate members complained afterward of the problems they had faced in their efforts to place such huge amounts of shares instantly in the market. 87/

86/ See, e.g., "The Regulation of Euroequities," Financial Times, October 22, 1986, at I-28; "Fiat and Libya Break Up," Fortune, October 27, 1986, at 14.

87/ See "Syndicate in Fiat Sale Faces Loss," New York Times, September 30, 1986, at D-1, col. 6.

Also cited in explaining the huge losses incurred by the syndicate members 88/ was the concern of investors with the impact of such a large flotation on the share price, which is quoted only on the relatively illiquid Milan exchange. Additionally, syndicate members complained of the lack of coordination of selling efforts, with many institutional investors being called by several underwriters and thus being able to play one against another for a better price. Finally, another factor that contributed to the problem was the perceived lack of a secondary market for the shares other than that in Milan. Since the offering, however, some underwriters, including Deutsche Bank itself, have made a market in the shares in an effort to facilitate their placement. 89/

c. Some Open Issues

The tone of doom in many of the descriptions of the Fiat deal and its problems indicates that some question seriously

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88/ Early estimates ranged from $100-200 million.

89/ The lead managers complained of the lack of patience of the underwriters, saying that the syndicate should not have expected to place such a large offering in only two days. The managers blamed at least part of the downward pressure on the stock's price on underwriters who they said were unloading shares in Milan due to their failure to quickly place their allotments.

the future of the Euroequity market. 90/ The doubt apparently centers on whether these offerings of international equities can be made through traditional Eurobond syndicates accustomed to dealing in debt issues. While many dealers make a market in Eurobonds, there is a far less well-defined secondary market for equity securities, with the home market being by far the most important. The Fiat offering illustrates the lack of a true international secondary market for some equity securities, and the problems that arise when the home market is unable to absorb the impact of such a huge offering. When the home market is the only viable secondary market for a large multinational issue, the securities may tend to flow back to that market soon after they are floated, depressing the share price.

Closer analysis of some of the factors involved in the failure of the Fiat deal, however, reveals that not only the sheer size of the offering but the probability that it was overpriced contributed greatly to its demise. Others maintain that the main cause of the failure was a lack of adequate disclosure of information regarding the company. 91/ In either case, relevant inquiries will be whether the market will self-

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90/ See notes 91 and 92, supra.

91/ See "The Regulation of Euroequities," supra, n.90.

correct and whether future issues will avoid such problems in both disclosure and marketing procedures.

Another question involves the type of investor involved in the Euroequity market. According to the issuers, among their goals in undertaking an international offering is the wide, relatively permanent placement of shares among individuals. This has certain benefits which justify some of the costs associated with an international placement. It appears highly questionable, however, whether the purchasers actually targeted in the equity offerings are individuals, or are the institutional investors that are targeted in debt offerings. This is apparent in part from the Fiat deal, where institutional investors played a major role in the events causing the placement difficulties. They initially balked at the high price, then played underwriters one against another when they were approached by more than one seller. This implies that instead of a firm placement with investors who may hold the securities, most of the Euroequity deals are being placed with institutions. This market may evolve into one no different than the Eurobond market, in which for many years the predominant investor was the "Belgian dentist", 92/ but which now is becoming dominated by large institutional investors.

92/ The term is commonly used to describe the stereotypical non-sophisticated investor in the Eurobond market who has a significant amount of disposable income.

5. United States Regulatory Considerations

a. Tax Law Considerations

As noted earlier, bonds must generally be available in bearer form in order to be saleable in the Euromarket. The provisions of the Tax Equity and Fiscal Reform Act of 1982 ("TEFRA") 93/ and the Interest and Dividend Tax Compliance Act of 1983 ("IDTCA"), 94/ however, require generally that all "registration-required obligations" be issued in registered form. 95/ Due to concern from the investment banking community, which was effectively communicated to Congress during its deliberations on TEFRA, there was included in that

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93/ Pub. L. No. 97-248, 96 Stat. 324.

94/ Pub. L. No. 98-67, 97 Stat. 369. IDTCA repealed the domestic withholding tax imposed by TEFRA, but imposed further information reporting requirements and set up penalty provisions, including a 20 percent backup withholding tax, for noncompliance.

95/ Registration-required obligations are generally those offered to the public by an entity other than a natural person and having a maturity of more than one year. I.R.C. Section 163(f)(2)(A).

act an exception from the registration requirement for Eurobonds. 96/

The "Eurobond exception" requires that all bearer bonds be issued under "arrangements reasonably designed" to ensure that they are not sold (or resold in connection with the original issuance) to United States persons; that interest be payable only outside the United States; and that there be placed on the bonds, as well as on each coupon, a legend describing the restrictions thereon. 97/ Compliance with the first of these requirements necessitates generally that either an opinion of counsel be obtained to the effect that registration under the 1933 Act is not required due to distribution only to foreigners, or that there be compliance with certification and confirmation requirements in offerings registered under the 1933 Act. 98/ These conditions must be met in order to avoid

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96/ I.R.C. Section 163(f)(2)(B). *See* discussion in Newburg, "United States Companies and International Financings," 20 Int'l Law. 765 (1986) (hereinafter cited as "Newburg"), at 766.

97/ I.R.C. Section 163(f)(2)(B).

98/ The tax law thus incorporates applicable securities law by this indirect reference to Release 33-4708, mentioned in the next section. The Treasury regulations are more direct in incorporating the securities laws. *See* Treas. Reg. Section 1.163-5(c)(2)(i), T.D. 8110, 51 F.R. 45453 (1986). *See also* Kau, "Recent Tax Law Developments on Eurobond Financings," *in* Practising Law Institute, *International Financial Offerings* (1985), at 157-58. The second alternative may also be satisfied if the
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imposition of sanctions on the issuance of long-term debt in bearer form and the imposition of the 30 percent withholding tax on payments of interest to foreigners. 99/

Although the passage of the Tax Reform Act of 1984 ("TRA 1984") 100/ made it possible for United States corporations to issue bearer bonds in the Eurobond market directly instead of through an off-shore finance subsidiary, there remained the problem of information and reporting requirements imposed by TEFRA. These requirements were strengthened with the enactment in 1983 of IDTCA, which added backup withholding provisions. 101/ Under temporary Treasury regulations, however, if the issuer of the bonds has no actual knowledge that the person to whom interest payments are made is a United States person, then the information reporting and backup

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securities are exempt under either Section 3 or 4 of the 1933 Act, or if the instruments are not securities within the meaning of that Act. Treas. Reg. Section 1.163-5(c)(2).

99/ I.R.C. Section 871(a) imposes the tax on interest and original issue discount income received from sources "within the U.S." by nonresident alien individuals.

100/ Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

101/ Section 104 of IDTCA added I.R.C. Section 3406, which requires the imposition of a 20 percent backup withholding tax in the case of certain failures in the reporting system.

withholding requirements do not apply. 102/ Additionally, simultaneous offerings of bonds to United States and foreign investors may be exempt from these requirements if, for example, the offering is registered with the Commission and includes domestic and foreign tranches, the latter of which is accomplished in compliance with Commission requirements as to final placement with foreign investors.

Therefore, under the present tax laws, 103/ United States corporate issuers can offer bonds directly in the Euromarket in bearer form, so long as they are placed with foreign investors. Although a large segment of the market, the FRNs, continue to be purchased and held mostly by institutional investors who are not as concerned with the anonymity that is generally sought by individual investors in the Eurobond market, ease of resale in the secondary market still dictates that most of these issues be made in bearer form.

The United States government and both official and quasi-governmental agencies are prohibited from issuing debt obligations in bearer form under the Treasury regulations. 104/

102/ Temp. Treas. Reg. Section 1.6049-5(b)(2).

103/ The provisions of the Tax Reform Act of 1986 do not change the provisions discussed herein.

104/ Treas. Reg. Section 1.163-5(c)(1). This is despite the fact that the Code allows such issuance. *See* T.D. 7965, 49 F.R. 33228 (1984).

This restriction is also extended to issues by corporate entities that are secured more than 50 percent by such obligations. 105/ Nevertheless, such issues may be done in such a manner as to accomplish their placement "anonymously" in foreign markets. Such an offering is known as a foreign "targeted" offering or a targeted registered offering. The foreign beneficial owner of such a security need not identify itself if the registered owner is a financial institution, interest is paid to the institution outside the United States, the issuer has no actual knowledge that a United States person is the beneficial owner of the obligation, and certain elaborate certification procedures are followed. 106/ This type of procedure has been used by governmental entities, and also by corporations in connection with such issues as mortgage-backed securities (collateralized by governmental agency securities) offered abroad in bearer form.

105/ *See* Sept. 7, 1984 letter from Treasury Secretary Regan to Senate Finance Committee Chairman Robert Dole.

106/ I.R.C. Sections 871(h) and 881(c). *See* Temp. Treas. Reg. Section 35a.9999-5; Newburg, *supra* n.93, at 771-71.

b. Securities Laws

In 1963, in an effort to reduce the United States balance of payments deficit and defend United States gold reserves, 107/ President Kennedy created the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad, which was chaired by Henry H. Fowler (the "Fowler Task Force"). The task force was charged with developing programs in several areas: an effort by the United States financial community to market securities of United States private companies to foreign investors, and to increase the availability of foreign financing for United States business operating abroad; a review of activities that adversely affect foreign purchases of the securities of United States private companies; and identification and appraisal of restrictions of other countries that hamper efforts by United States companies to sell securities and raise capital abroad from non-United States sources. 108/

107/ The United States remained on a fixed exchange rate system with the dollar backed by and convertible into gold until 1973.

108/ "Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad," Henry H. Fowler, Chairman, April 27, 1964, at v.

In connection with its analysis of possible actions of the United States financial community that should be taken in order to address the perceived problems facing the nation, the Fowler Task Force was primarily concerned with, inter alia, selling United States corporate securities abroad, adapting United States corporate securities to foreign securities markets, selling United States investment company shares abroad, and attracting foreign bank deposits. 109/ As a result of its study, the Fowler Task Force made several recommendations, including that the Commission issue a release setting forth the circumstances under which it would normally issue a "no-action" letter providing that no registration be required on public offerings of securities outside of the United States to foreign purchasers, including dealers. 110/ The Commission responded on July 9, 1964 to this recommendation by adopting Securities Act Release 33-4708 ("Release 4708").

Briefly stated, Release 4708 sets forth the Commission's position that it will generally not take enforcement action regarding sales of securities without registration under the 1933 Act so long as the offering has been completed under circumstances reasonably designed to prevent the distribution or redistribution of the securities into the United States or

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109/ Id., at 5.

110/ Recommendation No.4. Id., at 7.

to United States persons living abroad. Thus, despite the use of the jurisdictional means described in the 1933 Act, 111/ the Commission has decided not to apply the registration provisions of the Act in certain outlined transactions.

The recognized procedure for assuring that securities "come to rest" abroad has been to include affirmative clauses in the underwriting and selling group agreements not to sell the securities within the United States or to United States persons, and inclusion in the confirmations of sale representations that the final investors are not United States persons, and sales restrictions are imposed in the form of a "lock-up" period during which securities may not be sold to United States investors. 112/

111/ *I.e.,* means of interstate commerce or the mails. Securities Act Section 5.

112/ The policies and practices that have developed over the years under Release 4708 are currently the subject of reconsideration by the Commission. *See* discussion in Part VI of this chapter.

III. OVERVIEW OF UNITED STATES DISTRIBUTION METHODS AND DISCLOSURE REQUIREMENTS

This section summarizes the distribution techniques and disclosure practices of the United States. The discussion emphasizes the application of these standards to foreign entities seeking to sell securities in the United States. The discussion will provide a basis to compare the disclosure and distribution standards of the countries described in Part IV.

A. JURISDICTION

The registration requirements of the Securities Act apply, unless an exemption is available, whenever a person, directly or indirectly, "make[s] use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise, or carr[ies] or cause[s] to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale." 1/ The term interstate commerce includes "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia . . ." 2/ Pursuant to Securities Act

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1/ Securities Act Section 5(a).

2/ Securities Act Section 2(7).

Release No. 4708, however, the Commission has taken the position that registration will not be required if securities are "distributed abroad to foreign nationals even though use of jurisdictional means may be involved in the offering . . . [assuming] the distribution is to be effected in a manner which will result in the securities coming to rest abroad." 3/

The antifraud provision of the securities laws may apply, whether or not an exemption from registration is available. In connection with cases instituted under certain of the antifraud provisions the courts have applied two tests derived from international law to determine whether the federal securities laws have extraterritorial application: The conduct test and the effects test. 4/ The "conduct" test may be applied to determine whether jurisdiction over a transaction consummated at least partially abroad is appropriate due to conduct that occurred in the United States. Relevant inquiries include where the conduct in question occurred, and whether the conduct

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3/ The theory underlying this release is being reexamined in light of the changing global securities markets. See Part V, infra.

4/ See generally Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), modified on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); Leasco Data Processing Equipment Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1974), cert. denied, 423 U.S. 1018 (1975); IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980). For an extended discussion of jurisdiction, see Chapter VII, infra.

occurring within the United States was substantial in regard to completion of the overall scheme or fraud.

The "effects" test can support jurisdiction if acts were taken abroad that caused substantial and foreseeable harm to interests within the United States. 5/ The test rests on the theory that Congress wants to protect United States investors from improper foreign transactions that have such adverse effects on United States markets as artificially influenced prices and trading volume, and the erosion of public confidence. 6/

B. UNITED STATES DISTRIBUTION TECHNIQUES

Securities which are distributed within the United States are required to be registered under the Securities Act pursuant to Section 5 of that Act unless they are otherwise exempted by the Act. Under the Securities Act, only negotiations and agreements between the issuer and underwriters, or among underwriters who will be in privity of contract with the issuer, are permitted before filing of the registration statement with the Commission.

5/ *See* Part V for an expanded discussion of the jurisdictional tests in connection with the discussion of tender offer regulation.

6/ *Id.*, at 1108.

In the typical distribution, prior to filing the registration statement an underwriting group will be created by an "agreement among underwriters." Pursuant to this agreement, representatives of the underwriters negotiate with the issuer regarding the terms of the offering. The final underwriting agreement with the issuer is generally not executed until immediately prior to effectiveness. The underwriting arrangement may be a "firm commitment," whereby the underwriters assume the market risks, or a "best efforts" agreement under which the issuer assumes the market risks.

In the agreement among underwriters, the underwriters often authorize their representatives to reserve part of the issue for selling group dealers and institutional investors. The organization of this selling group must be delayed until after the registration statement is filed.

After filing, offers (but not sales) may be freely made pursuant to a preliminary, or "red herring," prospectus. It is during this period that solicitations are made and the selling group is formed, although no sales may be made prior to the effectiveness of the registration statement.

C. DISCLOSURE REQUIREMENTS FOR PRIMARY OFFERINGS

Disclosure requirements for public offerings of securities registered under the Securities Act and for periodic reporting under the Securities Exchange Act for foreign non-governmental

issuers are, in principle, the same as the requirements for domestic issuers. However, in practice, the Commission has attempted to adjust its disclosure requirements to accommodate foreign issuers. Separate registration and reporting forms have been adopted.

The registration statements available for foreign private issuers making distributions in United States markets are Forms F-1, F-2, F-3, F-4 and F-6. 7/ Form F-1 is used for initial public offerings. Forms F-2 and F-3 are available for foreign issuers that have previously registered securities under the Securities Act or the Securities Exchange Act. Forms F-2 and F-3 permit incorporation by reference of reports filed under the Securities Exchange Act, but Form F-2 requires delivery of those reports with the prospectus. Form F-3 is available only for issuers who have been reporting under the Securities Exchange Act for at least 36 months and who are "world class" issuers or are offering investment grade securities, securities issued upon exercise of certain rights or warrants, securities issued pursuant to a dividend reinvestment plan or upon

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7/ A Canadian foreign private issuer may use these forms only if it does not have or has not had during the twelve months prior to the filing of the form any class of securities registered under Section 12(b) of the Securities Exchange Act or a reporting obligation (suspended or active) under Section 15(d) of the Exchange Act and if such issuer has not issued its securities in a transaction to acquire by merger, consolidation, exchange of securities or acquisition of assets another issuer that filed or was required to file an annual report on Form 10-K.

conversion of outstanding securities or securities issued in a secondary offering. Form F-4 is available for business combinations.

Form F-6 is used for registration of American depositary shares evidenced by American depositary receipts. American depositary shares are shares issued by foreign issuers for sale in American markets. Such shares represent beneficial ownership in the foreign securities and are issued to avoid problems inherent in the ownership of foreign securities, such as collection of dividends and transfer problems. As the American depositary share is a security separate from the underlying shares of the foreign issuer, it must be registered for sale in the United States.

The disclosure required of foreign private issuers is similar to that required by domestic issuers. The principal differences are as follows:

(1) Foreign issuer financial statements must have an informational content substantially similar to that required of domestic companies. They need not be prepared in accordance with United States generally accepted accounting principles; however, they must be presented in accordance with accounting principles generally accepted in the domicile country and a reconciliation of significant variations from United States GAAP and Regulation S-X must be furnished. Reconciliation only of the differences in the measurement items (income statement and balance sheet amounts) is required in annual reports of

foreign private issuers and for offerings of certain non-convertible investment grade debt, securities issued upon exercise of certain rights, or warrants, pursuant to a dividend reinvestment plan, or upon conversion of outstanding securities. Full reconciliation of financial statements to United States generally accepted accounting principles and Regulation S-X (which sets forth the Commission's financial statement regulations) is required for other offerings.

(2) Unless a full reconciliation to United States GAAP is specified or required because of the nature of the offering or the securities, only revenue information need be broken into categories of activity and geographic markets ("segments") unless the total operating profit from each segment materially differs from their respective contributions to total sales and revenue, in which case narrative disclosure is required.

(3) Compensation of directors and officers need be disclosed only in the aggregate unless the issuer discloses such information to its shareholders or otherwise makes this information public.

(4) Information regarding transactions with management is required, but need be presented only to the extent the registrant discloses such information to its shareholders or otherwise makes public the information.

D. CONTINUOUS DISCLOSURE

Periodic reports must be filed with the Commission by any foreign private issuer with securities listed on a national securities exchange or NASDAQ (non-Canadian foreign private issuers with securities quoted on NASDAQ prior to October, 1983 are exempt from this requirement), and by issuers that have made a registered public offering in the United States. The reporting obligation for securities not listed on an Exchange or traded on NASDAQ may be suspended (except for a fiscal year in which a registration statement under the Securities Act becomes effective or is required to be updated) if the class of securities is held by less than 300 United States residents or less than 500 United States residents where the total assets of the issuer have not exceeded $5,000,000 on the last day of each of the issuer's three most recent fiscal years. 8/

The reports required are a Form 20-F, which must be filed within 6 months following the end of the issuer's fiscal year, and periodic Forms 6-K, which must be filed to furnish whatever information the issuer (1) is required to make public in the country of its domicile, in which it is incorporated, or organized pursuant to the law of that country, (2) has filed with a foreign stock exchange on which its securities are traded and which was made public by that exchange, or (3) has

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8/ 17 C.F.R. Section 240.12h-3.

distributed to its security holders. The Form 20-F calls for specific disclosure about the issuer's business, including financial statements reconciled to U.S. generally accepted accounting principles. As is the case with Securities Act filings, foreign issuer financial statements must have an informational content substantially similar to that required of domestic companies. However, they need not be prepared in accordance with U.S. generally accepted accounting principles and the Commission's Regulation S-X, if they are presented in accordance with accounting principles generally accepted in the domicile country and a reconciliation of the difference in measurement items (the income statement and balance sheet amounts) is provided.

Other foreign issuers would be required to register under the Securities Exchange Act if they have engaged in interstate commerce or in a business affecting interstate commerce or their securities are traded by use of the mails or any means or instrumentality of interstate commerce and they have assets of more than $5,000,000 and more than 500 shareholders worldwide. Exemptions from filing periodic reports are available, however, if the subject class of securities is held by fewer than 300 United States residents or the issuer furnishes to the Commission materials required to be made public pursuant to the law of the country of its domicile, required to be filed with a stock exchange on which its securities are traded and which

were made public by the exchange, or materials it is required to distribute to its security holders. 9/

E. LIABILITY

This section outlines the liability provisions contained in the Securities Act. Pursuant to Section 11 of the Securities Act, any person who acquired a registered security may bring suit if any part of the registration statement, when that part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. The plaintiff may sue every person who signed the registration statement (including the issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer and the majority of its board of directors or persons performing similar functions, and for a foreign issuer, its duly authorized representative in the United States); the issuer's directors, partners or persons about to become directors or partners of the issuer, "experts" who have with their consent been named within the registration statement as having prepared or certified part of the registration statement or a report or valuation used in connection with the registration statement,

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9/ 17 C.F.R. Section 240.12g3-2.

with respect to that statement, and every underwriter. Such persons are jointly and severally liable.

Reliance on the registration statement need not be proved in a claim under Section 11 unless the purchaser bought the security after the issuer had made generally available to its security holders an earnings statement covering a period of at least one year beginning after the effective date. If required, reliance may be established without proof of the reading of the registration statement. 10/

The issuer's liability is absolute unless it can show the plaintiff knew of the untruth or omission at the time of the acquisition of the security. Other defendants will not be liable if they can establish certain reasonable care defenses. 11/

Pursuant to Section 12 of the Securities Act, liability also attaches to any person who offers or sells a security in violation of Section 5, or who offers or sells a security by the use of interstate commerce or the mails by means of a prospectus or oral communication which includes misleading statements or omissions of material information. A reasonable care defense is available if the suit is based on untrue statements or omissions.

10/ Securities Act, Section 11.

11/ Securities Act, Section 11.

An action under either Section 11 or Section 12(2) must be brought within one year after the discovery of the untrue statements or the omission, or after discovery should have been made by the exercise of reasonable diligence. A suit under Section 12(1) must be brought within one year after the violation on which it is based. Further, the suits under Sections 11 and 12(1) must be brought within three years after the Security was bona fide offered to the public, and suits under Section 12(2) must be brought within three years after the sale. 12/

Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme or artifice to defraud; (2) to obtain money or property by means of any untrue statement or omission; or (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. This section is applicable to any offer or sale, not just those involved in registered offerings. Similarly, Securities Exchange Act Section 10(b) and Rule 10b-5 make it unlawful to engage in this conduct in connection with the purchase or sale of any security.

12/ Securities Act, Section 13.

IV. FOREIGN DISTRIBUTION METHODS, DISCLOSURE SYSTEMS AND LIABILITY PROVISIONS

The following discussion outlines the disclosure requirements and distribution practices for securities issued and sold in the European Economic Community ("EEC") and eight major industrialized nations other than the United States. T discussion of the EEC centers around several EEC Council directives that have been issued in connection with the progra of harmonization of companies laws of the member states, and which focus on disclosure requirements for securities that are to be listed on exchanges and accounting practices within the Community.

Each of the eight countries is then individually addresse according to the same format. The discussions focus on the various regulatory structures found in the countries and the nature of their implementing authorities. Major securities markets are identified and the means by which securities are commonly distributed therein are outlined. Liability provisions in the various countries are mentioned in each section. Currency translations are provided as appropriate in historic terms or at current exchange rates (December 1986).

A. EUROPEAN ECONOMIC COMMUNITY

Several of the countries discussed in subsequent parts of this chapter are members of the European Economic Community

(the "EEC"). Member states of the EEC have agreed, pursuant to the Treaty of Rome, to adopt and implement directives issued by the EEC Council of Ministers (the "Council"). The Council has adopted several directives proposed by the Commission of the EEC dealing generally with the harmonization of certain aspects of corporate and securities laws of the member states, including some disclosure provisions, and is considering the adoption of others.

The adoption of the various directives is in keeping with one of the goals of the EEC, which is to promote the abolition of obstacles to the free flow of capital among member states. The work being done in the area of securities regulation and stock exchange listing requirements is intended to smooth the operation of the EEC's stock exchanges and promote greater interpenetration of those markets. 1/

The procedure by which a Council directive becomes the law of a member state is complex and lengthy. 2/ The EEC

1/ G. Imbert, "Experience at the European Community Level," paper presented at the XI Annual Conference of the International Association of Securities Commissions (July 16, 1986).

2/ Directives differ from regulations in several respects, including the method of their implementation. While regulations are self-implementing and become law within the various member states without any further action by them, directives merely instruct the member states to pass laws that will implement the spirit of the directive. The period within which a particular directive must be implemented is uniform among the member states, but may vary for different individual directives.

Commission is responsible for drafting and recommending directives for issuance by the Council. Once a draft directive has been completed by the Commission, it is then studied by the Council and its staff. The input of member states is received at each stage of the process.

After the Council issues a directive, it must be adopted and implemented by the member states individually; however, each member state retains the right to choose the form or method of implementation. Absent a disagreement between the Commission and a member state, implementation is effected when a member state submits to the Commission a copy of legislation which, in the member state's opinion, fulfills its obligations under the directives. The terms of a given directive will establish a time period within which this must occur. Thus, the fact that a directive has been issued by the Council does not mean that it is the law of all member states. To the contrary, many of the directives mentioned below have not been fully implemented by several of the member states. Failure to implement a directive by a member state may subject it to infringement proceedings before the Commission.

The directives relevant to this study include those regarding admission of securities to listing on an exchange; disclosure by companies which have listed securities or which propose to sell to the public securities that are to be listed; and minimal accounting standards.

1. Directives Regarding Securities to be Listed on an Exchange

The Council of the EEC has adopted three directives regarding listing requirements in an effort to, among other things, provide equivalent protection to investors at the Community level, facilitate the listing of companies on the various exchanges of the member states, and achieve greater interpenetration of national securities markets within the Community in order to contribute to the establishment of a European capital market.

Official action by the member states to implement the directives was to be accomplished by June 30, 1983. As of April 1987, all member states, with the exception of Portugal and Belgium, had implemented the directives. Portugal has submitted draft legislation which is being modified to achieve compliance. Belgium, however, has not yet passed legislation that complies with the terms of the directives.

a. Listing Directive

The first of the directives regarding listing requirements is the Council Directive of 5 March 1979 coordinating the conditions for the admission of securities to official stock

exchange listing (the "Listing Directive"). 3/ In addition to giving details of minimum conditions that must be met prior to listing on an exchange in a member state, the Listing Directive sets forth certain continuing obligations of issuers whose securities are so listed. 4/ The terms of the Listing Directive clearly indicate that member states have discretion to require such further information as is necessary to protect investors or to ensure the smooth operation of the market. 5/ Broad, simultaneous dissemination is to be made of the information required on a continuing basis. 6/

The conditions for listing are not extensive. 7/ In the case of shares of common stock, the company and the shares to be listed must be in compliance with the laws to which the company is subject. The company must have a minimum

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3/ 22 O.J. Eur. Comm. (No. L 66) 22 (1979). The directive need not be applied to certain unit trusts and investment companies or to securities issued by governmental entities of the member states. Art. 1.

4/ The specified conditions may in certain cases be made more stringent regarding both listing and continuing obligations. Listing Directive, Arts. 5.1, 5.2.

5/ Listing Directive, Art. 13.

6/ Listing Directive, Art. 17.

7/ These are set forth in the Listing Directive at Schedule A for the admission of shares and Schedule B for the admission of debt securities to listing.

capitalization of at least one million European Currency Units ("ECU"), 8/ and must have published or filed at the appropriate domestic agency its annual reports for the three financial years preceding the application for admission to listing. The shares must be freely negotiable and widely enough distributed to the public to ensure proper operation of the market for the shares. 9/

Similar requirements concerning legality of the securities and the company's status must be met with regard to debt obligations. The minimum amount of the subject debt offering must be at least 200,000 ECU, except in certain cases where a deviation is appropriate and a sufficient market for the debt securities will exist. Exchangeable or convertible debt

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8/ The Directive actually refers to "European units of account". However, by Council Regulation of Dec. 20, 1980, 23 O.J. Eur. Comm. (No. L 345) 1 (1980), promulgated after the adoption of the ECU, all references in official EEC documents, including the Listing Directive, to European units of account were replaced by the ECU. ECU's are artificially created currency units comprised of a "basket" of currencies of several of the member states. Thus, the particular value at any given time of an ECU vis-a-vis another European currency that is included in the basket will vary according to applicable foreign exchange rates. Notably absent from the basket of currencies comprising the ECU is the British pound sterling.

9/ This requirement is deemed to be satisfied when at least 25 percent of the subject class of shares is distributed to the public, but may be satisfied with a lower percentage if there is a large number of shares outstanding.

instruments and those to which a warrant is attached may be listed only if the underlying securities are listed on a recognized exchange.

The Listing Directive sets forth certain continuing obligations for issuers of shares and debt obligations listed on an exchange. 10/ Such issuers must, among other things, (1) ensure equal treatment for all security holders in the same position; (2) ensure, at least in each member state where its securities are listed, that all necessary facilities and information are available to enable security holders to exercise their rights; (3) make available to the public, as soon as possible, its most recent annual accounts and annual report; (4) inform the public as soon as possible about any major new developments in its sphere of activity which are not public knowledge and which may lead to substantial movements in the prices of its shares or may significantly affect its ability to meet its obligations; and (5) if the issuer has securities listed on more than one exchange, assure that the same information is made available to the market of each of those exchanges.

10/ Listing Directive, Schedules C and D, respectively.

b. Information Directive

Disclosure of information regarding securities being offered to the public that are to be listed on an exchange is the subject of a separate directive. Standards for disclosure are set forth in the Council Directive of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (the "Information Directive"). 11/

Admission of securities to listing on an exchange must be conditioned upon the publication of an information sheet regarding the issuer and the securities to be listed. 12/ The information required is that which is necessary "to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching" to the subject securities. 13/ Thus, in addition to required disclosures in the Schedules to the Information Directive, the Directive calls for that information

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11/ 23 O.J. Eur. Comm. (No. L 100) 1 (1980).

12/ Information Directive, Art. 3.

13/ Information Directive, Art. 4.

which is necessary to meet the foregoing standard. 14/ Provision for exemption from the obligation to publish information may be made by the member states in certain enumerated cases. 15/

The scope of the required information depends on the nature of the security being offered and the persons to whom it is offered. 16/ The information is to be supplemented by the annual accounts for the latest financial year of the issuer. The areas of required disclosure for shares (and other equity related offerings) generally cover information concerning (1)

14/ Information Directive, Art. 5.1.

15/ For example, publication may not be required upon application for listing for securities that have been the subject of a public issue, that were issued in connection with a takeover offer or in connection with certain merger transactions if, within the past 12 months, a document containing information substantially equivalent to that required by the Information Directive has been published. Other exemptions may be instituted by the member states for, among others, securities allotted free of charge to existing security holders, or shares issued pursuant to conversion or rights.

16/ Distinctions are made between shares and convertible or exchangeable securities offered on a preemptive basis, those offered to the public in general, debt securities of an issuer that already has securities listed on the same stock exchange, debt securities that because of their nature are bought and traded largely by a limited number of investors who are knowledgeable in investment matters, securities issued by financial institutions or guaranteed by a separate entity, and convertible or exchangeable debt securities. Information Directive, Arts. 8 through 17.

those responsible for preparing the document and for auditing of accounts; (2) the shares and the listing application; (3) the issuer and its capital; (4) the activities of the issuer; (5) the assets and liabilities, financial position and profits and losses of the issuer; (6) administration, management and supervision of the issuer; and (7) recent developments and prospects for the issuer. 17/ Areas of disclosure for debt securities include generally the same types of information, except information concerning loans of the company instead of a description of the company's shares is given. 18/ In the case of certificates representing shares, additional information must be given regarding the issuer of the certificates and regarding the certificates themselves. 19/

The Information Directive also specifies certain arrangements to be established for the scrutiny and publication of the information required. No such information may be published until the document has been approved by the competent authorities of the appropriate member state, who must determine that the document contains all information required by the

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17/ Information Directive, Schedule A.

18/ Information Directive, Schedule B.

19/ Information Directive, Schedule C.

Information Directive. 20/ The information must be published a "reasonable period" before the listing is to become effective, and should either be inserted in a widely circulated newspaper or provided in a free brochure.

Significant differences exist between the Information Directive requirements and comparable United States disclosure requirements. A few examples of disclosure requirements under the Directive illustrate these differences: (1) with respect to segment information, the Information Directive requires only a breakdown of net turnover by category of activity and geographical markets for the previous three years; (2) only the total amount of remuneration paid to administrative, management and supervisory bodies must be disclosed; (3) only comparatively limited information concerning unusual transactions between the issuer and management must be given, as must the total of all outstanding loans to administrative, management and supervisory bodies; (4) limited information regarding business experience and background of management is required; and (5) disclosure of shareholder interests below an established threshold need not be made, and this threshold may be set by member states at as high as 20 percent of the equity. In each case, the United States securities laws would require greater disclosure. It also should be noted that a number of EEC disclosure requirements of the Information Directive are

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20/ Information Directive, Art. 18.

applicable only in the case of equity related offerings and do not apply to debt securities. Further, the Information Directive applies only to securities which are to be listed on an exchange. 21/

c. Interim Report Directive

The third directive regarding requirements for issuers with securities listed on an exchange is the Council Directive of 15 February 1982 on information to be published on a regular basis by companies with shares that have been admitted to official stock-exchange listing (the "Interim Report Directive"). 22/ The Interim Report Directive applies only to equity related securities. 23/ The Interim Report Directive

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21/ This difference would be eliminated should the proposed directive for disclosure by companies whose securities are not to be listed on an exchange be adopted by the Council and implemented by the member states. The proposed directive was submitted by the Commission to the Council on Jan. 13, 1981, and a revised text was submitted on July 19, 1982, but no formal Council action has yet been taken.

22/ 25 O.J. Eur. Comm. (No. L 48) 26 (1982).

23/ The Interim Report Directive actually applies only to issuers who have shares listed on an exchange. However, because the Listing Directive requires that underlying shares be listed for all listed convertible or exchangeable debentures or those with warrants attached, issuers of such debt securities are also covered by its terms.

requires generally that issuers publish half-yearly reports on their activities and profits and losses during the first six months of each financial year. 24/ It must be published within four months of the end of the period, and must include figures as well as explanatory notes. 25/ The report is to be published in a widely circulated newspaper or otherwise made easily available to the public, and must also be sent to the competent authorities in the appropriate member state. 26/

2. Accounting Directives

The EEC, as a part of its general effort to harmonize the laws relating to companies, has also issued three directives relating to accounting standards. The Fourth Council Directive of 25 July 1978 regulates the contents of the annual accounts and reports of issuers that must be disseminated in accordance with the requirements of other directives. 27/ The directive includes minimum standards for balance sheets and profit and loss accounts, establishes valuation rules and prescribes rules

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24/ Interim Report Directive, Art. 2.

25/ Interim Report Directive, Art. 4.

26/ Interim Report Directive, Arts. 7, 8.

27/ 21 O.J. Eur. Comm. (No. L 222) 11 (1978).

for the content of annual reports and notes to the annual accounts. It also requires auditing of the annual accounts.

The Seventh Council Directive of 13 June 1983 provides for drawing up of consolidated accounts and annual reports for parent enterprises with one or more subsidiaries. 28/ It prescribes the layout and contents of the accounts and reports and also requires that they be audited. Finally, the Eighth Council Directive of 10 April 1984 provides standards for education, training and testing of auditors and qualification of auditing firms. 29/

28/ 26 O.J. Eur. Comm. (No. L 193) 1 (1983).

29/ 27 O.J. Eur. Comm. (No. L 126) 20 (1984). For further discussion of accounting standards in various countries, *see* Chapter IV, *infra*.

B. UNITED KINGDOM

The structure and the activities of the securities market in the United Kingdom are in an extremely fluid state. This is due principally to the ending, in October 1986, of certain restrictive practices on The Stock Exchange in London (the "Stock Exchange") 1/ -- the "Big Bang" -- and the recent creation by legislation of a new regulatory system. This section therefore discusses both the regulatory system in effect at the time of writing and that which is soon to become effective, insofar as details are available.

Investor confidence in the prior self-regulated financial and securities market has been undermined in recent years by several financial scandals, and the new system, although still dependent on self-regulation, reflects an attempt to restore public and international confidence. The changes are intended to re-establish London as the world's largest and most internationalized securities market. London's geographical location makes it a natural center, together with New York and Tokyo, of the emerging 24-hour global securities market.

To a large extent, the international and domestic markets are interrelated in London. This section of the report,

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1/ The term "Stock Exchange" refers to a single organization that regulates the activities of the various stock exchanges located around the United Kingdom. The Stock Exchange has recently changed its name, pursuant to reorganization, to the International Stock Exchange of the United Kingdom and the Republic of Ireland.

however, focuses principally on the United Kingdom domestic securities markets. 2/

1. Description of Statutory Scheme and Regulatory Authority

a. Source of Regulation

There is no comprehensive body of securities law in the United Kingdom, and no single agency is responsible for administration of securities matters. Matters such as the registration of new companies with, and the grant of incorporation by, the Registrar of Companies, the contents of prospectuses and liabilities for misstatements therein, and the duties of officers and directors were, until recently, governed by the common law as supplemented by the Companies Act 1985 (the "Companies Act"). 3/ The recent Financial Services Act 1986 (the "Financial Services Act") 4/ has superseded or will

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2/ While discussion of the securities markets in this paper relates to securities activities throughout the United Kingdom (the vast majority of which takes place in London), certain aspects of the regulatory system discussed herein relate only to Great Britain and not to Northern Ireland.

3/ 1985 Chapter 6.

4/ 1986 Chapter 60.

supersede many of the Companies Act provisions relating to prospectus disclosure.

Under the Financial Services Act and the Companies Act, all prospectuses and annual reports (which must include audited accounts) are filed with the Registrar of Companies, who is responsible to the Department of Trade and Industry ("DTI"). 5/ In addition to such statutory provisions, disclosure and reporting requirements are imposed (by authority granted under the Financial Services Act) by the Stock Exchange for companies listed thereon. Additionally, both the rules of the Stock Exchange and the City Code on Takeovers and Mergers, applicable to most large companies, prescribe the disclosures to be made to shareholders in the event of a takeover bid and the manner in which such transactions shall be conducted. The Stock Exchange is an independent body and the City Code, which is not backed by force of law, is administered by the City Panel, staffed by appointees from the securities industry.

The regulatory framework regarding marketing of shares and the issue of shares on takeover or exchange was established

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5/ New regulations to be drafted pursuant to the provisions of the Financial Services Act will replace the Companies Act requirements relating to the contents of prospectuses for unlisted securities. Practitioners expect the new requirements to be closer to the disclosure requirements presently applicable to securities listed on the Stock Exchange. The requirements are expected to be published later in 1987; this paper considers the requirements presently in effect under the Companies Act.

principally by the Prevention of Frauds (Investment) Act 1958 and is now also covered by the Financial Services Act.

Regulation of securities professionals depended until recently on whether they were members of the Stock Exchange, which sets examination, capital requirements and other qualifications for membership. Under the new regulatory framework established by the Financial Services Act, all persons who "carry on investment business" in the United Kingdom must register with the Securities and Investment Board ("SIB"), an agency funded by the securities industry with powers delegated by Parliament.

b. Extent of Regulation

The scope of regulations concerning the issue and trading of securities is somewhat less extensive than in the United States. The initial raising of capital is less expensive in that less filings and the employment of fewer professional advisors are involved, and requires less disclosure than in the United States, especially for those companies which do not list on the Stock Exchange. 6/ While an offer of securities to the

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6/ See discussion of markets in the next section. Disclosure required under the Companies Act which, apart from the general legal requirement of disclosure of material facts, is all that applies at present to non-listed companies, is not extensive. See discussion of disclosure requirements. For a variety of reasons, arguably cultural, United Kingdom (continued . . .)

public (the Financial Services Act refers to an offer by "advertisement") must be made by a prospectus containing the disclosures set out in the Companies Act, a wholly private offering -- a sale of unlisted securities to institutional investors, for example -- need not even comply with these requirements, and no filings or applications for exemption need be made. 7/ Disclosure requirements for Stock Exchange listed companies are more comparable to those of the United States (see below), but prospectuses still tend to be shorter.

While the raising of capital by unlisted companies is not subject to qualitative review, issues of securities for which listing is sought are subject to the qualitative review by the Quotations Department of the Stock Exchange described below.

(. . . continued)
prospectuses are more concise, and drafted with a less stringent view on materiality, than their United States counterparts. Factors involved are generally thought to be the much lower rate of corporate litigation in the United Kingdom, the lack of class action suits and contingency fees, and the larger proportion of sophisticated institutional investors in the United Kingdom.

7/ There is very little case law on the nature of a private offering. As discussed below, the requirement to register a prospectus under the Financial Services Act is premised on the use of an "advertisement", an undefined term. There is, of course, no judicial interpretation of this term as yet.

c. Jurisdiction

The extent of extra-territorial jurisdiction claimed by the UK regulatory agencies has never been subject to much discussion. Sections 159 and 160 of the Financial Services Act (for listed and unlisted securities, respectively) provide that no advertisement offering securities on a stock exchange or to the public may be issued "in the United Kingdom" without registration of a prospectus. No attempt is made to regulate the sale of securities to United Kingdom citizens overseas, and British companies making offerings totally overseas are not required to register their prospectuses in the United Kingdom.

2. Nature of Securities Markets

The United Kingdom securities market has a considerable international flavor. As of autumn 1986, securities of companies and governmental agencies from at least 37 countries were listed on the Exchange. 8/

The Stock Exchange ranks third in the world in terms of market capitalization, with approximately £1,353 billion ($2,000 billion) as of the end of 1986. Of this, equity

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8/ The Republic of Ireland exchanges are also accommodated within the Stock Exchange. Additionally, the Stock Exchange has a computer-linked office in Johannesburg to facilitate transfer of London-listed South African securities.

represents some £284 billion ($419 billion). Some 6,840 securities are listed on the Stock Exchange, of which 4,980 are company securities, 607 are public sector securities, and 1,253 are Eurobond issues. 9/ Securities may either be fully listed on the Stock Exchange 10/ or traded through the Unlisted Securities Market ("USM"). The USM was established by the Exchange in 1980 as a forum off the floor of the Stock Exchange 11/ for small or new companies with a need for capital but an insufficient track record for full listing. Compared to the Stock Exchange's five-year requirement, USM companies need only to have been traded for three years. USM quotation costs are approximately half those of full listing. 12/ Some 360

9/ Stock Exchange Quarterly, Autumn 1986.

10/ To list on the Stock Exchange, a company must have published or filed accounts in accordance with its national law covering the five years preceding application for listing (although the Exchange has discretion to modify this requirement). The company must not have relationships with substantial shareholders that could result in conflicts of interest and the securities for which it applies for listing must have an expected market value of £700,000 (currently about $1,032,500) for equity, and £200,000 (currently about $295,000) for debt.

11/ Most trading of fully listed securities now also takes place off the Exchange floor.

12/ Such costs account for approximately 1-1/2 to 2 percent of the amount raised. This compares favorably to NASDAQ quotation upon a primary offering, for example, which usually amounts to around 5 to 7 percent of the amount raised.

companies of the 496 originally listed on the USM are still traded there and about 50 are now fully listed on the Stock Exchange. Present USM companies have capitalization of between £600,000 and £137 million (currently about $885,000 and $202 million), and have proved particularly attractive to individual shareholders. 13/

The Stock Exchange also provides, by its rule 163(2), a facility for occasional dealings in the securities of unlisted and unquoted companies through Stock Exchange brokers, who will find buyers and sellers. Before the Exchange will grant permission for such a deal to be made, evidence of "genuine business activity", the company's latest accounts and copies of any recent prospectuses must be submitted to the Department of Quotations.

The UK over-the-counter ("OTC") market is run by specialist organizations dealing in the securities of an increasing number of companies not traded on the Exchange, some of which are fairly substantial. These firms may act as market makers, as brokers matching buying and selling orders, or both. Trading is predominantly by telephone. Investors may also contact an unlisted issuing company directly, to ascertain whether the secretary knows of an interested buyer or seller. Such sales are not regulated. OTC trading of listed securities is permitted in the United Kingdom.

13/ Statistics are as of Autumn 1986.

In 1986, the Stock Exchange established an electronic "Third Market" on which the equity securities of small United Kingdom companies not meeting the listing requirements of the Exchange or the USM may be traded in lieu of trading on the OTC market. Sponsors of companies applying to list on this market must arrange for at least two market-makers to deal in these companies' shares.

3. Issuers

Domestic as well as foreign companies and governmental agencies raise money in the United Kingdom securities markets. In general, no distinction is made between residents and non-residents in the capital-raising process. Foreign issuers are led numerically by the United States, with Japanese, Canadian, German, South African and Dutch issuers following substantially behind. United States issuers represent over six percent of the total capitalization of the USM.

United Kingdom government bonds ("gilts") are issued by the Bank of England acting as agent for the government. All domestic company issuers in the capital markets are public companies, which comprise the great majority of United Kingdom companies. Private companies (those registered as such with the Registrar of Companies in order to take advantage of the greater privacy afforded thereby) are precluded from raising funds in the public markets.

As of the beginning of 1986, there were 2,688 companies with equity shares listed on the Stock Exchange. Foreign companies accounted for 572 of this total. Of the listed companies, 89 were newly authorized in 1985 to list their equity on the Stock Exchange, with 17 of these being foreign issuers. There were new listings in 1985 of bonds and debentures totalling £57 billion ($73,884.2 million), as compared with listings of £34 billion ($45,397.2 million) on the Stock Exchange in 1984. The domestic private sector accounted for £10 billion ($12,559.6 million) of the 1985 total, the domestic government for £20 billion ($26,245.8 million) and £27 billion ($35,078.7 million) were international issues. 14/

4. Types of Securities Traded

Debt, equity and convertible securities of all the issuers described above are traded in the United Kingdom securities markets. The value of domestic debt securities exceeds that of equity securities, but trading volume in equity securities is higher.

Government bonds are the most widely traded instrument in the United Kingdom and have a deep and liquid market. Such

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14/ International bonds include Eurobonds and foreign bonds.

securities account for 90 percent of the value of fixed interest securities and 80 per cent of the value of all securities issued in the United Kingdom, but only 20 percent of the volume of securities traded, since investors tend to hold them longer than other types of securities. The remaining fixed interest securities are issued by public companies. In addition to frequently taking advantage of the status of a Stock Exchange listing for Eurobonds (<u>see</u> Part II, <u>supra</u>), foreign issuers often choose to issue "Bulldog Bonds" (sterling denominated debt securities managed by British banks).

The full range of securities traded in the United Kingdom markets, debt and equity, are listed on the Stock Exchange. Both debt and equity securities may be listed on the USM, but the majority of issues are equity. Equity securities are issued in registered form, while debt securities may be issued in either registered or bearer form. Rights issues are common, although the former strict regulations requiring the issuance of preemptive rights by companies have been relaxed. Rights issues may be traded on the Stock Exchange.

Two types of options, "traditional" and "traded", are available in the United Kingdom. Traditional options may only be granted by the company, and may not be traded subsequently. Traded options are closer to United States options, in that they may be bought or sold at any time, and are available on the stocks of many United Kingdom companies. There is also a market in unit and investment trusts (mutual funds). As of

late 1986, there were approximately 900 unit trusts in the United Kingdom with a value of around £21 billion ($30 billion), approximately one-tenth of the value of United States mutual funds. A market for limited partnership interests does not seem to have evolved.

5. Primary Offerings

a. Participants in a Distribution

In the primary market, corporate securities are issued and usually underwritten by a merchant bank or stockbroker (the "issuing house"), although debt securities are not always underwritten. Most important domestic issues are listed on the Stock Exchange, and an applicant for listing must appoint a member of the Stock Exchange to sponsor its application. This sponsor is responsible, among other things, for ensuring that the Quotations Department of the Stock Exchange is given all information which should be brought to its attention and for lodging with the Department all the documents required to support the application for listing.

The nature of the sponsoring institutions is presently undergoing change. As part of the run-up to the "Big Bang", foreign individuals and domestic and foreign corporations have been allowed to acquire interests in member firms of the Stock Exchange, and the composition of the participants in primary

securities offerings has changed dramatically. Banks are not prohibited from securities activities and a number of banks (overseas branches of American banks in particular, because their securities activities are restricted in their home market under the Glass-Steagall Act), have acquired interests in or formed partnerships with Stock Exchange member firms.

The usual way in which shares or debentures are offered to the public is by an "offer for sale". The issuing house agrees to purchase or subscribe for a block of securities, then offers them to the public at a (higher) fixed price or by means of a "tender". 15/ The public is invited to submit applications on forms attached to the prospectus. The issuing house renounces its allotment in favor of the applicants, thereby saving stamp duty, which is payable on the transfer of securities. Although the securities are actually sold by the issuing house, for disclosure purposes the Companies Act treats the document distributed to the public as a prospectus issued by the issuer. The sponsor arranges for financial institutions, either brokers or banks, to underwrite the issue. The underwriters agree to

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15/ A tender offer invites subscribers to offer to buy shares at a price that is determined by reference to the bids submitted. Shares are distributed to the highest bidding subscribers at a uniform price which is based upon the lowest bid at which a sufficient number of equal or higher bids exists such that the number of securities bid for by such bidders equals the amount of securities to be sold in the offering.

take up shares in the event that the public does not submit sufficient applications. 16/

Alternatively, securities may be "placed" directly with financial institutions. This involves distribution without advertisement to a number of institutions and others who have already indicated interest. Since this method favors the large investor and deprives small investors of an opportunity to acquire securities at bargain prices, the Stock Exchange requires that at least 25 percent of the securities of the class being issued (10 percent for the USM) be in public hands (whether in the United Kingdom or elsewhere). Such placings require special approval by the Stock Exchange.

Placings may be made in one of two ways. An issuing house may subscribe for the issue and then invite its clients (e.g., insurance companies and pension funds) to purchase from it at a higher price. Alternatively, an issuing house or stockbrokers or a bank may, without subscribing, act as agents for the company and invite their clients to purchase securities from the company. Placings are often used for issues of foreign securities, where there is less likely to be public interest in the issue. They are the most common method of distribution on the USM.

16/ It is also possible to make a direct invitation by prospectus to the public. This method is rarely used except by government borrowers.

Typically, a large issue of securities involves a lead manager, a group of managers, and a selling group, which may also be underwriters. In order to participate in the distribution of securities in the United Kingdom, institutions must be either authorized to do so or exempt under the Financial Services Act. The lead manager usually has an agreement with the company setting out their respective roles and including certain warranties and undertakings by the company as to the accuracy of the documents being distributed. This agreement sets out the basis of remuneration for the managers and the various commissions payable either by the managers or the company to the parties involved in the distribution.

The Bank of England exercises control over the timing of issues of sterling securities where the amount of money to be raised is £3,000,000 or more, in order to maintain an orderly new issue market. The sponsor of a primary offering must apply for a date known as "impact day," upon which the size and terms of the issue may be announced. The publication requirements of the Stock Exchange ensure that investors are aware of new issues and can apply for printed prospectuses and application forms. Typically, the prospectus appears in advertisement form in at least one newspaper.

There has been a recent trend towards security ownership

by individuals. 17/ This trend has been encouraged by the current British government in the recent sales of shares in nationalized industries. One aspect of new issues favoring the small investor is that all subscriptions of 500 shares or less are usually filled even if the issue is oversubscribed. Institutional purchases are cut back, if necessary, to ensure that members of the investing public get the shares they request. Nevertheless, historically, the investors in whose hands primary distributions have ended up have been largely institutions, and large institutional investors such as pension funds and insurance companies still hold half of all securities issued.

b. Disclosure and Review

In general, the nature of the disclosure to be made by an issuer depends on whether the securities are to be listed (on the Stock Exchange or the USM) or unlisted. If the decision is made to list the securities, the nature of the disclosure further depends on whether the offering is by an issuer who has been listed previously on the Stock Exchange.

The Companies Act (soon to be superseded by regulations under the Financial Services Act) regulates the contents of

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17/ Recent polls indicate that just over 8 percent of the population owns shares (MORI, June 1986).

prospectuses for securities (listed or unlisted) offered by advertisement. 18/ The Financial Services Act provides for exemptions from the prospectus requirement to be granted by the DTI's Secretary of State, inter alia, where an advertisement has a "private character" (possibly by reason of a connection between the person issuing it and those to whom the advertisement is addressed) and advertisements addressed to persons "sufficiently expert to understand any risks involved."

The current statutory textual disclosure requirements are principally set out in the Third Schedule to the Companies Act, and are designed mainly to provide information about:

- The directors and what benefit they will receive from their directorships;
- The profit being made by the promoters;
- The amount of capital required by the company to be subscribed, the amount actually received or to be received in cash, and the precise nature of the consideration given for the remaining capital;
- The company's financial history;

18/ The concept of an "advertisement" plays a similar role to the ideas of "public offerings" or "distributions" in other countries' securities laws. Only public companies may invite the public to subscribe for shares. Private companies (i.e.- all those not registered at Companies House as public companies) are subject to an effective embargo on access to the capital markets and must raise their capital privately.

- The company's obligations under contracts into which it has entered, and for commission and preliminary expenses;
- The voting and dividend rights of each class of shares; and
- The nature of assets to be acquired with the proceeds of the offering.

Financial disclosures are prescribed by the Fourth Schedule of the Companies Act and must include:

- A report by the company's auditors, dealing with the profits or losses in each of the five financial years immediately preceding the issue of the prospectus (or since incorporation) and giving the rates of dividends paid on each class of shares during the same period;
- Assets and liabilities of the company as of the last date which the accounts were made up;
- If a company has subsidiaries, profits and losses and assets and liabilities either for each subsidiary individually or for the group on a consolidated basis; and
- If the proceeds of the securities to be issued are to be applied to the purchase of a business or of shares in another company, an accountants' report

on the profits or losses of such business or company for the last five financial years, and its assets and liabilities as of the last date on which accounts were made up.

A draft directive of the EEC, which would increase somewhat the disclosure requirements relating to securities not listed on a stock exchange, will, if adopted by the Council of the European Communities, require EEC member states to prescribe prospectus requirements comparable to those for listed securities (discussed below). 19/

Compared with United States disclosure requirements, both financial and non-financial disclosures under the Third and Fourth Schedules are much less extensive. Compensation of directors is only addressed to the extent that it is governed by any provisions in the articles (which are comparable to the by-laws of a United States corporation). Neither the employment histories of the directors nor the amounts of compensation paid to them are required to be disclosed. The projected use of the capital raised need only be detailed in so far as it involves working capital or the purchase of property. The accounts required by the Schedules are also much less extensive than in the United States. Segment reporting is required for classes of business in respect of turnover and

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19/ *See* discussion in III.A., *supra.*

profit and loss, and for geographical markets in respect of turnover. This information may be withheld, however, if the directors believe it to be in the company's interests to do so.

Copies of prospectuses must be filed with the Registrar of Companies before the date of their publication. 20/ The copies must be signed by all the company's directors, and must have attached to them the consent of any expert named in the prospectus to the use of the expert's report. Copies of contracts described in the prospectus must be attached, as must a statement concerning adjustments permitted to be made in accountants' reports. Prospectuses that comply with these requirements are registered by the Registrar, after which they may be used. There is no substantive or merit review of such prospectuses.

More extensive disclosure is required in the prospectuses or "listing particulars" used for securities to be listed on the Stock Exchange. It should also be noted that listing particulars are required in some cases, such as rights issues, where the Financial Services Act deems that no advertisement is

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20/ In the case of very large issues (such as the recent British Telecom and British Gas issues) and Eurobonds it is customary to circulate a "pathfinder" prospectus amongst interested institutions to gauge interest in the issue. Such prospectuses are filed with the Registrar of Companies and in the case of large issues (although not generally with Eurobonds) with the Stock Exchange. There are no statutory provisions or Stock Exchange rules relating to pathfinder prospectuses.

made and that therefore no prospectus need be registered. The disclosure requirements established by the Council of the Stock Exchange are set out in "Admission to Securities for Listing," known as the "Yellow Book," and include and expand upon disclosure requirements established by the EEC for all exchange-traded securities. These requirements are incorporated in most EEC member-countries' statute books.

Disclosure of information regarding the issuer of listed securities is in general comparable to that required by the United States in Regulation S-K and Form 20-F. The disclosure covers:

- Identification of the company, the persons responsible for statements made in the prospectus, and the issuer's auditors, bankers, brokers, and lawyers;
- The securities issued, including exchanges where listed;
- Nature and amount of issue, and details of other securities outstanding;
- Rights of the securities being issued and how they may be affected by the rights of other securities;
- Price, method of distribution and method of delivery of securities;
- Estimated net proceeds and commissions paid;
- Details of the issuer's capitalization;
- Identification of controlling persons;

- Description of the issuer's activities, including a breakdown of net turnover in the last 3 years by categories of activity and by geographical markets, if material (segment information);
- Description of management, including names, addresses and functions of directors and founders (if a new business), other business interests of such persons, details of service contracts, aggregate remuneration paid to directors and estimate of amounts to be paid during the current year;
- Recent trends in the issuer's business and its prospect for the current financial (fiscal) year; and
- Where forecasts are made, the assumptions forming the basis for such forecasts.

Financial disclosure under the Yellow Book includes:

- Independent accountants' reports covering profits and losses, assets and liabilities, financial record and position of the issuer (and its group, if applicable) for each of the last 5 financial years;
- Where such financials are more than 9 months old, interim financials covering the first six months of the current financial year;
- A statement that the annual accounts are audited (or if not, why not) and an indication of other

information in the listing particulars that has been audited by the auditors;

- Profit or loss per share of the issuer for the last 3 financial years and the amount of dividend per share for such years;
- Any significant changes in the financial or trading position of the issuer or group since the date of the latest financials;
- A table showing the source and application of funds of the issuer (or group) over each of the past 3 financial years;
- Details of holdings in companies representing 10 percent or more of the issuer's capital and reserves or its net profit or loss;
- Consolidation principles used; and
- Disclosure as of the most recent practicable date (on a consolidated basis if material) of the issuer's loan capital outstanding, total amount of other indebtedness, mortgages and charges and contingent liabilities.

The Stock Exchange requires accounts of companies incorporated outside the United Kingdom to be prepared in conformity with international accounting standards as promulgated by the International Accounting Standards Committee and specified by the Exchange. At present compliance with the

International Accounting Standard relating to segment reporting is not required.

Principal differences between the requirements of the Stock Exchange and the United States focus on the disclosures required regarding director remuneration, the age of financial statements and the extent to which segment information is required. Prospectuses in the United Kingdom tend to be more forward looking generally than those used in the United States.

USM disclosure requirements generally cover the same matters as those covered by the Yellow Book, but in more general terms and with less specific disclosure required. In particular, less detailed information is required regarding the terms of the issue and the nature of the securities offered. Financial disclosure is somewhat less detailed than in the case of listed companies, and there is no requirement that financials be audited. Financials must be produced for the latest five financial years, or since incorporation. Material changes, if any, since the date of the last accounts, must be described. The prospectus must contain a statement to the effect that the securities described will not be admitted to full listing on the Stock Exchange.

Upon application for listing with the Stock Exchange, the applicant company is required to file substantial documentation with the Quotations Department for review. This documentation includes:

- An application form signed by the sponsor and supported by two member firms prepared to register as dealers of the security;
- Copies of the Listing Particulars, one of which is signed and dated by each director;
- Information on the company and its directors;
- The company's constitutional documents and board resolutions relating to the offering;
- Specimen certificates representing the securities; and
- Other documentation supporting the issue, including a letter from the sponsor regarding the accuracy of the director's opinion as to the adequacy of working capital.

Copies of these documents generally are submitted some four weeks prior to hearing of the application by a panel of the Quotations Committee. Final proofs are submitted 14 days prior to the hearing; the actual documents two days before the hearing. Prior to this formal meeting, the staff of the Quotations Department will have reviewed the documentation. The panel's decision on admission is given at the hearing. The Stock Exchange is authorized by regulation to reject an application to listing if, in its opinion, the company's situation is such that admission would be detrimental to investors' interests. In exercising this qualitative judgment, the Stock Exchange relies to a certain extent on the sponsor's

heavy responsibility under the Exchange's rules to ensure that a company is suitable for listing on the Exchange and that its directors are prepared to comply with the Exchange's reporting requirements.

By regulation there is a right to judicial review of the Stock Exchange's decision. Judicial review is limited to consideration of whether such a decision is within the Exchange's authority and has been arrived at on reasonable grounds by fair procedures.

Upon acceptance for listing, listing particulars may be distributed. The Stock Exchange requires publication of listing particulars and notices of the issue in newspapers. Where listing particulars are published in a newspaper, the address at which printed copies of the listing particulars are available must be stated.

No material distinctions are drawn between new and established issuers, and the Stock Exchange disclosure provisions outlined above apply equally to an issue of securities by an issuer that has made offerings previously. Listing particulars are not required, however, where the shares to be issued are of a class already listed, and either the issue will not increase that class by more than ten percent, or the shares issued will be allotted to employees. When an issuer whose shares are already listed issues shares by way of rights, less disclosure is required, although listing particulars are still required. Debt offerings by issuers who

have any type of securities already listed, or convertible debt offerings by issuers whose shares are already listed, require somewhat less disclosure, although more than would be required under a fully integrated disclosure system.

6. Secondary Market

Most multi-capacity securities dealers, particularly retail banks and stockbrokers, are involved in secondary trading. Merchant (investment) banks usually limit their secondary trading to large blocks of securities. Many individual stockholders are involved in the secondary market, although large institutional investors are the major participants in the secondary government securities market.

Continuing reporting obligations are imposed by both the Companies Act and the Stock Exchange. 21/ The Companies Act requires that annual returns be filed with the Registrar of Companies. These set out the company's registered office, the location of its share and debenture registers, capitalization,

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21/ As in primary trading, prospectuses are not required unless offers are made to the public. The Financial Services Act provides that registered prospectuses must be used in "secondary offers". These include offers made by advertisement by persons who acquired securities from the issuer with the intention of issuing such an advertisement, where the securities are not listed and have not been held as an investment by the offeror, or where the offeror is a controlling person of the issuer.

calls on shares, details of indebtedness, lists of past and present members, and its directors and secretary. The Companies Act also requires that annual financial reports be sent to shareholders at least 21 days before the shareholders meeting at which such reports are to be approved. However, accounts need not be filed with the Registrar. The shareholders meeting of public companies must take place within seven months of the end of the fiscal year.

The Stock Exchange's continuing disclosure requirements, many of which arise from EEC directives, cover the following:

- Annual reports and accounts, to be issued within six months of the end of the relevant financial period;
- Half-yearly or interim reports which need not be audited, to be sent to holders of securities or published in newspapers; and
- Directors' reports to accompany annual accounts, explaining why results differ from any forecasts, providing a geographical analysis of turnover and net contribution, and detailing the company's borrowing, the country of operation of subsidiaries, the amount of interest capitalized, any material contracts, and the directors' interests in shares. If applicable, the report must also state that shareholders have no pre-emptive rights as to new shares.

Generally, listed companies have a duty to disclose information necessary to prevent a false market arising in their securities, and the Stock Exchange prescribes regulations regarding the activities of listed companies to this end.

7. Liability

Under the Financial Services Act, the persons "responsible" for listing particulars or prospectuses are liable to pay compensation to persons suffering loss by reason of untrue or misleading statements therein. Reasonable belief in the accuracy of a statement or the propriety of an omission is a defense. "Persons responsible" include the issuer, its directors, and persons named as accepting responsibility for the document or authorizing the contents of any part of it. Actions under the common law torts of negligent misstatement and deceit may also be available to aggrieved investors.

The Financial Services Act also imposes criminal liability for breach of its requirements relating to prospectus disclosure.

8. Rating System, Withholding Tax, Limitations on Transferability

The United Kingdom has no rating agencies similar to those operating in the United States. However, a new credit rating agency, EuroRatings Ltd., issued its first ratings on March 9, 1987, from its London office. Promoted and majority-owned by Fitch Investors Service, Inc. of New York, EuroRatings has been designed with the stated goal of providing a full service rating system for the international markets. Although the agency will rate Sterling issues, it will concentrate on all types of issues in the Euromarket, including Eurocommercial paper and Eurobonds offered by both private and sovereign issuers, and will also rate international bonds.

Withholding taxes are payable on interest earnings except where reduced or eliminated by tax treaties, and while dividends are declared net of advance corporation tax ("ACT"), residents of countries that have tax treaties with the UK may claim a tax credit for the amount of ACT paid, less a withholding tax of 15 percent.

Stamp duty of half of one percent is payable on the transfer of securities, whether in the primary or secondary markets. This has been reduced in recent years from two percent.

Under English law, there is no restriction on transfer of securities to foreigners. No distinction is made between

resident and non-resident investors. There are no currency exchange controls, so the proceeds of investments may be repatriated easily.

(THE NEXT PAGE IS III-120)

C. JAPAN

1. Description of Statutory Scheme and Regulatory Authority

The basic body of Japanese securities law is contained in its Securities and Exchange Law of 1948 (the "SEL") which is patterned on the United States Securities Act and Securities Exchange Act. 1/ The principal aspects of the SEL are: (1) registration and disclosure requirements applicable to primary offerings; (2) periodic disclosure requirements; (3) proxy, insider trading and short-swing profit provisions; (4) provisions regulating securities companies and exchanges; (5) civil and criminal liability provisions; and (6) a prohibition against commercial banks engaging in securities business. 2/ The Japanese

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1/ Law No. 25, April 13, 1948.

2/ Act 65 of the SEL prohibits banks, trust corporations, and certain other financial institutions from engaging in any securities business except where (1) the bank purchases or sells securities on written order from, and for account of, a client; (2) the transaction is made for its own investment purposes and/or for the account of its trustors' accounts on the basis of trust contracts pursuant to the provisions of other laws; or (3) the transaction involves government or municipal bonds, corporate bonds or debentures and other debt securities with respect to which principal and interest are guaranteed by the government. The SEL provisions are currently under attack by the banking industry in much the same way as is the Glass-Steagall Act in the United States.

Japanese securities laws are administered by the Securities Bureau of the Ministry of Finance ("MOF"). Cabinet and MOF orders and rules of self-regulatory organizations 3/ supplement Japanese securities legislation. In particular, numerous regulations have been promulgated interpreting the SEL and forms have been adopted setting forth required disclosure for various types of offerings. The principal regulations regarding public offerings of securities are:

(1) Securities and Exchange Law Enforcement Order (Cabinet Order No. 321);

(2) Ministerial Ordinance Concerning Registration, etc. of Public Offerings or Secondary Distributions of Securities (MOF Ordinance No. 5); and

(3) Ministerial Ordinance Concerning Registration, etc., with Respect to Public Offering or Secondary Distribution of Foreign Government Bonds, etc. (MOF Ordinance No. 26).

2. Nature of Securities Markets

There are eight stock exchanges in Japan: Tokyo, Osaka, Nagoya, Kyoto, Hiroshima, Fukuoka, Niigata and Sapporo. The

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3/ The Securities Dealers Association of Japan and the stock exchanges are the primary self-regulatory organizations.

Tokyo, Osaka and Nagoya exchanges each have, in addition to the regular market, a "second section" for the listing of equity shares in which the number of listed shares, shareholders or volume of trading is relatively small compared with the regular trading market. 4/ Foreign securities may be listed only on the "foreign section" of the Tokyo Stock Exchange (the "TSE").

Each securities exchange has regulations governing the purchase and sale of securities and the listing and delisting of securities. The SEL prohibits any person other than a registered securities exchange from establishing any facility that is similar to an exchange. Commission rates are generally set by each exchange.

Stock exchange rules generally require exchange members to trade listed securities, whether debt or equity, only on the exchanges. There are exceptions, however, such as one permitting block trades of bonds, which results in a large portion of debt trading taking place off the exchanges. Virtually all trading of listed stocks is done on the exchanges.

An issuer of securities traded over-the-counter must register the securities with the Securities Dealers Association as over-the-counter securities. The number of securities registered in this manner is small, apparently because of the

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4/ Listing requirements for the second sections are less strict than those on the principal exchange.

second sections of the exchanges. The association has registration standards that are similar to the listing standards of the securities exchanges.

The market had a capitalization of Y277.8 trillion ($1,746 billion) at the end of 1986 based on domestic exchange-listed stocks with market value of investment companies excluded. From 1984 to 1986, the Japanese equity market grew 68 percent (measured in United States dollars).

3. Issuers

The number of domestic companies listed on the TSE at the beginning of 1986 was 1,499. The number of companies traded on the Tokyo Stock Exchange foreign section reached 55 as of March 1987, up from 21 at the end of 1985. 5/

4. Types of Securities Traded

Japan's bond market has expanded rapidly during the past decade, with government bonds the most widely traded of the debt securities. Total trading volume of bonds on the TSE and the over-the-counter markets in Tokyo increased to Y2,826 trillion ($16.7 trillion) in 1986, from Y2,288 trillion ($9.6

5/ United States companies account for 33 of these. See Chapter 2, Table 14.

trillion) in 1985. There were 854 listed debt issues on the TSE at the beginning of 1986.

In addition to yen-denominated bonds issued by Japanese residents, a large market exists for bonds issued by foreign persons or in foreign currencies in Japan. Among the various types of foreign bonds are "samurai" bonds (yen denominated bonds), "shogun" bonds (bonds denominated in a foreign currency, usually dollars), and "sushi" bonds (similar to shogun bonds, but issued by a Japanese company).

5. Primary Offerings

a. Participants in a Distribution

Underwriting syndicates composed of Japanese securities firms handle the bulk of debt and equity issues in Japan, which may be made on a firm commitment or a best efforts basis. Japanese commercial banks are prohibited from engaging in the distribution of securities. Foreign securities firms are prohibited from participating in securities transactions with any person residing in Japan unless they have obtained a license from the MOF or the transaction is made through a licensed firm.

b. Disclosure Requirements

The SEL prohibits any public offering or secondary distribution of securities 6/ unless a registration statement is in effect with respect to such offering. 7/ Under the SEL, similar to the United States statutory scheme, certain transactions and securities are specifically exempted from operation of the Act. The term "public offering" is defined as "a solicitation of an offer to acquire securities which are to be newly issued from unspecified, many persons on uniform terms." 8/ The term "secondary distribution" means "an offer

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6/ Unlike the United States securities laws, the SEL does not include investment contracts in its definition of security. Thus, interests in Japanese limited liability companies, limited partnerships, voting trust certificates and securities depositary certificates are not considered to be securities. Certificates in securities investment trusts and loan trusts are exempt from registration under the SEL but are regulated by the Securities Investment Trust Law and the Loan Trust Law.

7/ The entire registration statement is to be made available for public inspection at the Ministry of Finance, the exchange on which securities of the issuer are listed (or the securities dealers association with which securities of the issuer are registered) and the principal or main branch offices of the issuer.

8/ SEL, Art. 2, Section 3. The MOF has taken the position that the registration requirements also extend to rights offerings, which constitute the principal method of raising funds by registered issuers. The incidence of capital formation by rights offerings is a matter of custom, since

(continued . . .)

to sell or a solicitation of an offer to buy securities which are issued and outstanding to or from unspecified, many persons on uniform terms." 9/ Ministry of Finance guidelines provide that an offering to more than about 50 is an offer to "many".

Public offerings or secondary distributions with an aggregate issue or selling price of less than Y100 million (currently about $624,000) are generally exempt (this aggregate amount includes any exempted public offering of the issuer within the past two years). 10/ The registration and prospectus delivery requirements do not apply to Japanese government bonds, to certain secured bonds or to certain other securities issued pursuant to special statutes.

Once a registration statement is filed, an offer to sell or the solicitation of an offer to buy may be made but securities may not be sold until the registration statement is effective. 11/ The registration statement technically becomes effective 30 days after filing. The current practice, however, is for the registration statement to be declared effective on

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(. . . continued)
Japanese corporate laws do not impose preemptive rights.

9/ SEL, Art. 2, Section 4.

10/ SEL, Art. 4; MOF Ordinance No. 5, Art. 2.

11/ A shelf registration system is scheduled to be introduced next year.

the second full business day following the final amendment to the registration statement. A prospectus must be delivered by the seller (or the underwriter or securities company) before or simultaneous with the sale. These prospectus delivery requirements apply for a period of three months from the date of filing (except for securities listed on a securities exchange) with respect to sales of the remaining part of securities unacquired after the public offering.

The registration statement must include audited, but unconsolidated, financial statements for the latest two fiscal years. Balance sheets and profit and loss statements for an additional 3 years must be filed with the registration statement, but need not be included in the prospectus.

Disclosure requirements are prescribed by forms published by the MOF under its rulemaking authority, as further supplemented by interpretive rules and releases. The Japanese disclosure system requires substantially less disclosure than that required by the Securities Act of 1933. For example, Japan does not have legal requirements for registrants to include any additional material information necessary to make the required statements not misleading. At present, there is uncertainty as to whether the registrant's obligations are satisfied merely by the mechanical process of responding to specific items in the registration form.

Textual disclosure requirements include:

- Detailed description of the securities offered and the terms thereof, legal rights thereunder and corporate authority;
- Use of proceeds;
- Issuer information (generally limited to a brief history, schedule-type reconciliation of the issuer's capital stock, shareholder schedules, ratio and statistical data, and market data);
- Schedules listing subsidiaries, officers and directors and employees;
- Outlines of the business including business objectives, nature of the company's business and material management contracts;
- Description of the business operations and facilities focusing on manufacturing capacity, orders received and sales results;
- Description of the issuer's financial condition for and at the end of the last two fiscal years, including the contents of principal asset, liability and income and expense accounts; and
- A cash flow projection for the six month period immediately following the most recent recorded period with accompanying production goals, expansion plans and an explanation of difficulties foreseen in their accomplishment.

Japan's textual requirements thus do not include many significant 1933 Act disclosure concepts such as summaries of the offering, risk factors, transactions with management, executive compensation, management's discussion and analysis, and dilution. However, for diversified corporations, the registration statement must describe the business carried out by the registrant and the major products and the relative weights of each line of business. Issuers also must state the amount of production, orders and sales of each product for two fiscal years, including the monthly average. Profit and loss information as to lines of business, such as separate net income, is not currently required. However, the MOF has decided that companies with listed stocks will be obligated beginning in spring of 1988 to disclose the divisional or regional profit and loss, or segment information. The MOF is currently undertaking a study of the contents and method of disclosure of segment information, taking into consideration concerns of investors and industry.

There has been a recent simplification of the disclosure system applicable to registration statements for companies which have disclosed information continuously for at least five years. For such companies, the annual report will be allowed to be incorporated by reference in the registration statement, and effectiveness of the registration statement may be declared as early as 15 days after filing.

With a few exceptions, the distribution practices and disclosure requirements for non-Japanese issuers are similar to those of Japanese issuers. Generally, foreign issuers are required to have pre-filing conferences with the Corporate Finance and Capital Market Divisions of the MOF's Securities Bureau and also with the International Finance Bureau. Foreign issuers are also required to obtain a certification under the Foreign Exchange and Trade Control Law of 1949 prior to issuance. Registration documents must be submitted in English and Japanese and a Japanese agent must be appointed.

If the MOF determines, on an individual basis, that it is not detrimental to Japanese investors and the public interest, financial statements may be prepared in accordance with the GAAP of a foreign issuer's domicile and certified by auditors in the issuer's domicile in accordance with its domestic GAAS. If the financial statements published in the home country are consolidated, only those need be included. The registration form for foreign issuers requires prospectus disclosure of the differences from Japanese accounting principles together with disclosure of legislation and tax laws in the issuer's domicile affecting Japanese investors. Supplemental Japanese audits are not required.

c. Listing Requirements

To be listed, a company must file an application with the exchange. The application will be examined by the exchange in accordance with the exchange's listing regulations. If, after conducting its examination, the exchange considers listing appropriate, it will authorize listing subject to the approval of the MOF. A foreign company seeking listing must appoint a securities company from among members of the exchange to process the application. Generally, an application for listing is slightly more detailed than an annual securities report filed under the SEL and includes unconsolidated financial statements for the last three years and consolidated financial statements for the last two years.

The listing criteria for foreign applicants on the TSE differ from those for domestic companies in that slightly higher standards are required in certain areas. Generally, to avoid restrictions on the number of shares that may be traded, at least 20 million shares of a foreign company must be listed. "Good liquidity" must exist in the home market, and shareholders' equity must exceed Y10 billion (currently about $62.4 million), or Y1 billion (currently about $6.2 million) for domestic companies. Net profit before taxes must have exceeded Y2 billion (currently about $1.2 million) for the last three business years (for domestic companies this requirement is Y400 million (currently about $2.5 million), Y300 million

(currently about $1.9 million) and Y200 million (currently about $1.2 million), respectively, for the last three business years). There is no restriction on the transfer of shares once listed.

The TSE has no rules regarding the voting rights of shareholders. As a matter of policy, however, it does not permit listing of ordinary stocks with no voting rights, in order to promote responsiveness of corporate management. Nevertheless, in special cases the Exchange has permitted shares with limited voting rights to be listed. 12/ Preferred stocks may be issued without voting rights, so long as the right to vote is given if a dividend payment is not made. 13/

6. Secondary Market

a. Purchasers

Equity ownership at the beginning of 1986 was distributed as follows: financial institutions, 39.6 percent; individuals, 26.3 percent; business corporations, 25.9 percent; foreigners, 6.1 percent; securities companies and government, 2.1 percent.

12/ As of March 12, 1987, three stocks with limited voting rights, all of them Swedish, were listed on the TSE.

13/ Commercial Code, Art. 242, para. 1. As of March 12, 1987, only one preferred stock was listed on the TSE.

The principal purchasers of debt are banks and other institutional investors.

Foreign investment in Japanese equity securities has increased substantially. Foreign purchases of stocks increased dramatically in 1980, when the Foreign Exchange and Foreign Trade Control Law of 1980 14/ ("FEL") eased investment procedures for foreign investors and lifted ceilings on foreign investment in a specific company. This trend lasted through 1983, but in 1984, 1985 and 1986 there was a net disinvestment by foreign persons in Japanese stocks. Foreign investment in Japanese bonds also declined in 1986, with net purchases totalling $2.3 billion (Y386 billion) in 1986.

b. Continuous Disclosure Obligations

Issuers of (a) securities listed on any Japanese securities exchange, (b) securities registered with a securities dealers' association as over-the-counter quoted securities, and (c) securities that are not listed or quoted but are subject to a registration requirement under the SEL (that have not obtained an exemption from the MOF) are required to file with the MOF annual, semi-annual and extraordinary

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14/ Law No. 228, Dec.1, 1949.

reports. 15/ The Exchange requires foreign companies to file quarterly reports as well. The financial statements contained in the annual report need not be consolidated; however, consolidated financial statements for the last two fiscal years must be attached. The semi-annual report must be filed within three months after the end of the first half of the fiscal year by domestic companies and within six months by foreign companies. The semi-annual report must contain audited financial statements.

Extraordinary reports must be filed promptly upon the occurrence of certain events. These include:

(1) the issuance of securities abroad;
(2) the issuance of securities in excess of Y100 million (currently about $624,000);
(3) changes in parent corporations or subsidiaries;
(4) changes in the identity of major stockholders; and
(5) material adverse events.

The Japanese Commercial Code also requires preparation of annual financial statements. These financial statements are slightly different from those prepared under the SEL. Accordingly, most public Japanese corporations prepare at least two sets of financial statements. The exchanges also impose

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15/ SEL, Art. 24.

requirements for submission of reports and for notification and disclosure of material information.

7. Liability

The liability provisions of the SEL were originally modeled after Sections 11, 12 and 13 of the Securities Act, although they have been amended, first to narrow their scope, then to strengthen the system of civil liability. 16/

Civil liabilities are imposed under the SEL as follows: (1) on the issuer, persons who make a secondary distribution, underwriters and securities companies for violation of the prohibition on sale of unregistered securities or failure to deliver a prospectus in a public offering or secondary distribution requiring registration; 17/ (2) on any person "who had another person acquire securities by use of a prospectus" or representation containing misstatements or omissions of material facts; 18/ (3) on the issuer, officers, persons who make a secondary distribution, certified public accountants and underwriters for misstatements or omissions in

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16/ The SEL also contains criminal provisions.

17/ SEL, Arts. 15 and 16.

18/ SEL, Art. 17.

the registration statement; 19/ (4) on officers and the owner in a secondary distribution for misstatements or omissions in the prospectus to any person who "acquired the securities in response to the public offering or secondary distribution and being delivered the prospectus in connection therewith." 20/ Liability is also imposed for violations of prohibitions on market manipulation, short-swing trading and similar provisions.

Defenses are available where the person who acquired the securities knew of any untruth or omission. In the case of misleading statements or omissions in the registration statement or prospectus, due diligence defenses are provided to persons other than the issuer.

8. Transfer Taxes, Rating System, Foreign Exchange Control

Securities transfer taxes are payable by a seller depending on whether the seller is a securities company. The tax on sale of shares is 0.18 percent for a securities company and 0.55 percent for other persons. For privately issued bonds, the tax is 0.015 percent for securities companies and 0.045 percent for others. For government bonds, the tax is

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19/ SEL, Arts. 18, 19, and 21.

20/ SEL, Art. 21.

0.01 percent for securities companies and 0.03 percent for other persons.

At present, there are four rating agencies in Japan. These credit agencies are the Japan Bond Research Institute, Japan Credit Rating Agency, Ltd., Mikuni & Co. and the Nippon Investors Service, Inc. 21/ The latter two rate only domestic corporate bonds, while the Japan Credit Rating Agency rates only domestic commercial paper. The Japan Bond Research Institute rates not only commercial paper and corporate bonds but international bonds issued by both private companies and sovereign states as well. These ratings are used in determining compliance with certain eligibility standards for samurai bonds and for Euroyen bonds issued by non-residents.

The FEL subjects certain transactions to prior notification and/or clearance of varying degrees by the MOF. The standards for approval have apparently been relaxed over the last few years. Pursuant to the FEL, notification is required for (1) issues of securities outside Japan by Japanese residents; (2) issues of foreign currency securities within Japan by Japanese residents; (3) issues of securities within Japan by Japanese non-residents; (4) flotation outside Japan of yen-denominated securities; (5) acquisitions of more than a certain percentage of foreign securities by a Japanese

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21/ Mikuni & Co. is the only one of these rating agencies not formally recognized by the Ministry of Finance.

resident; and (6) secondary acquisitions whereby a resident of Japan buys foreign currency securities from a non-resident, or a non-resident acquires securities (regardless of currency) from a resident unless a regulated securities company participates in or is party to the transaction.

The acquisition of common shares by a non-resident of Japan from a Japanese resident (whether an individual or a corporation) from or through a MOF-designated Japanese securities company acting as intermediary is in general not subject to any restriction. However, if the result of such acquisition is that a particular foreign investor will hold ten percent or more of the total common shares outstanding of a Japanese company, the non-resident must file a report prior to the acquisition with the MOF. Similarly, acquisitions by non-residents of shares from other non-residents are unrestricted unless the ten percent threshold is reached.

D. CANADA

1. Description of Statutory Scheme and Regulatory Authority

Canada has a federal system of government, with legislative authority over particular subject matters allocated between the federal and provincial levels of government. Securities regulation, like most aspects of corporate law, is under provincial jurisdiction. Federal jurisdiction exists over certain federally-incorporated corporations, banks, and financial institutions. Transactions in the securities of such entities may therefore be subject to federal as well as provincial regulation.

Each of the ten Canadian provinces and two territories has its own securities legislation, although the laws of British Columbia, Alberta, Manitoba, Saskatchewan and Ontario are very similar. 1/ Compliance with the requirements of any one of these provinces will normally ensure acceptability in the others. The provincial securities commissions are headed by administrators appointed by the various provincial and territorial governments.

1/ Ontario's securities legislation, introduced in 1945, was the first modern Canadian legislation on this topic, and emphasizes full disclosure. Its Securities Act of 1966, upon which the other four provinces' acts are patterned, is referred to as the Uniform Act.

While in theory the provincial authorities are of equal power, the Ontario Securities Commission ("OSC") and, more recently, the Commission des valeurs mobilieres du Quebec (Quebec Securities Commission or "QSC") and the Alberta Securities Commission have wielded greater influence than the others. This discussion will therefore concentrate on the requirements of these authorities, especially those of the OSC.

Subject to certain exemptions outlined below, all primary distributions of securities are prohibited unless the trader of securities is registered, and the securities are "qualified for sale" -- that is, registered by the filing of a prospectus or similar document with the relevant commission.

Prospectus disclosure requirements are derived from the respective provinces' securities acts, regulations, and forms prescribed under such regulations and apply whether or not the securities to be issued are to be listed on a stock exchange. 2/ In general, no additional or alternative disclosure is required by any of the Canadian stock exchanges. 3/

2/ Some provinces' company law statutes also include provisions regulating the issuance of securities, but in general defer to the securities acts in matters such as disclosure.

3/ The Toronto Stock Exchange ("TSE") and the OSC have, however, recently developed the Exchange Offering Prospectus. This is designed to foster capital formation by junior mining and industrial companies. By complying with rules prescribed by the TSE, an

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Additionally, various Policy Statements supplement or interpret securities legislation and regulations. Because each province has a different (although often very similar) securities act, Canadian securities administrators meet semi-annually to coordinate requirements, and their association publishes National Policy Statements. Uniform Act Policy Statements are published by the five Uniform Act provinces, and most provinces have their own Policy Statements issued by their securities commissions.

The provinces' securities acts cover such matters as insider trading and liability for misstatements in prospectuses. Securities fraud and most other matters concerning regulation of the securities markets are dealt with at a federal level under the provisions of the Criminal Code of Canada.

Securities professionals are regulated by the provincial securities commissions. No person may trade in securities or act as underwriter unless registered with the appropriate securities commission or exempt from registration.

In Ontario, for example, securities dealers are divided into several categories. The principal categories include brokers, who are registered to trade securities as principals

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(. . . continued)
issuer may raise up to C$5,000,000 (currently about US$3.6 million) by distributing its shares through the TSE without having to comply with the OSC's prospectus requirements.

or agents and who are members of the Toronto Stock Exchange ("TSE"); investment dealers; securities dealers (who may trade as principal or agent but who are not members of the TSE); and mutual fund dealers. Other jurisdictions have similar categories. Persons registered as brokers or dealers in Ontario are deemed to have been registered as underwriters. In some jurisdictions, self-regulatory organizations have been delegated full or partial authority to approve registration of their member firms' officers and sales staff. Provincial securities administrators are also charged with the recognition and regulation of stock exchanges in their provinces.

Regulation of the Canadian securities markets resembles that of the United States in both nature and scope, except for the localized nature of the regulation. The jurisdiction of the Canadian provinces is not necessarily asserted in securities transactions not taking place in or affecting the province in question, although the statutory provisions are broad enough on their face to enable such an exercise. For example, the broad definitions found in the Ontario Securities Act imply that a distribution of securities outside Ontario by either Ontario or non-Ontario issuers might, given certain jurisdictional links, require compliance with the prospectus registration provisions of Ontario law. An interpretation note published by the OSC concludes, however, that where reasonable steps are taken to ensure that an offering of securities comes to rest outside Ontario, a prospectus complying with the

Securities Act or an exemption from the provisions thereof will not be required. Extraterritorial offerings are therefore viewed in much the same way as in the United States under Securities Act Release No. 4708.

An issuer making a distribution of securities from Quebec to persons outside Quebec must, under Section 12 of Quebec's Securities Act, prepare and register a prospectus unless the QSC grants an exemption (or does not object to the offering upon receipt of certain information.) 4/ Such application for an exemption has been refused only once to date.

2. Nature of the Securities Markets

The principal Canadian capital markets are in Ontario. The Toronto Stock Exchange ("TSE") is one of the world's largest exchanges in terms of both capitalization and trading volume. Other exchanges are located in Montreal, Vancouver, Calgary and Winnipeg, but the TSE accounts for 75 percent of the total value of stocks traded in Canada.

Montreal accounted for over 20 percent of the total volume of shares in Canada until 1977, when the provincial legislature

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4/ Under Quebec Securities Act Regulations Section 115, this information includes the date of the distribution, estimate of the value of securities, the authority that will be reviewing the offering documents, a copy of the documents filed with that authority, and the name of the dealer to be used.

established French as the official language of Quebec. Banks and other financial institutions relocated to Toronto and by 1980 trading volume in Montreal had fallen by half. Volume has risen somewhat since then.

The Vancouver Stock Exchange ("VSE") styles itself a venture capital market for the natural resources industry. It has less stringent listing requirements than other Canadian exchanges and accepts listings from many speculative mining and energy resource companies. Shares are somewhat comparable to United States penny stocks and trading volume is very high.

The Alberta Stock Exchange in Calgary lists mostly regional securities and junior resource companies. The Winnipeg Stock Exchange has no trading floor, and trading, mostly in oil, mining and energy related stocks, is conducted by telephone.

An active over-the-counter market, the only market in which debt securities may be purchased, is maintained between investment dealers and brokers. Transactions may also be made through a chartered bank.

3. Issuers

Canada's bond market is dominated by the government. Both the federal and provincial governments issue securities. Corporate issuers issue both debt and equity securities, but many Canadian companies are owned by United States corporations

which raise capital on a group-wide basis in the United States. There are therefore fewer corporate issuers in the Canadian capital markets than the size of the Canadian economy would lead one to expect. Foreign issuers seldom raise capital in the Canadian markets.

As of the beginning of 1986, there were 966 companies with equity shares listed on the TSE. Foreign companies accounted for only 54 of this total. Of the listed companies, 73 were newly authorized in 1985 to list their equity on the TSE, with 4 of those being foreign issuers. On the Montreal exchange as of the beginning of 1986 there were 490 companies with equity shares listed. Foreign companies accounted for only 19 of this total. Of the listed companies, 71 were newly authorized in 1985 to list their equity on the Montreal exchange, with one of those being a foreign issuer.

4. Types of Securities Traded

A wide variety of instruments, comparable to those available in the United States, are issued and traded in the Canadian markets. Most of these are traded on the stock exchanges, although debt securities, both government and corporate, are confined to the over-the-counter market and are not listed on any exchange. Both registered and bearer form bonds are available and interest is typically paid semi-annually.

Options are available on many stocks. The Montreal Stock Exchange used to account for half of the volume of options trading, but this has now dropped to around one quarter. In recent years, the VSE has introduced silver and Canadian currency options.

Mutual funds are growing in size and popularity. Shares in mutual funds are not listed and may be purchased from fund managers.

5. Primary Offerings

a. Participants in a Distribution

Securities firms may act as underwriters of, and best efforts agents for, public offerings of securities. 5/ Banks have previously been restricted in their securities activities, although at least one bank has entered the market recently by confining its participation to one province, thereby avoiding federal regulation. Recent changes in federal regulations allow banks to participate at the inter-provincial level through ownership of securities dealers. It is likely that participants in the future will include several foreign (mostly United States, United Kingdom and Japanese) firms as

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5/ Best efforts offerings are relatively rare in Canada.

limitations on foreign participation in the securities markets are lifted.

In a large deal, one investment dealer typically will act as a lead underwriter and be responsible for forming a co-underwriting group or syndicate. Formal documentation will govern the relationship and liabilities between the underwriter and the issuer and among the co-underwriters or syndicate group members.

Advertisements for public offerings are limited to "tombstones," and may be made once the relevant securities commission issues a receipt for a final prospectus.

The parties to whom a public offering will be sold will depend on factors such as the type of security, the nature of the issuer and the size of the issue. Securities firms, banks, investment companies and trust companies all are significant purchasers of new issues, and substantial portions of new issues typically are sold to institutions. Many financial institutions face strict regulation regarding the type of investments they can make; thus legal opinions on the suitability of the securities for purchase by such institutions are often included in the prospectus.

As of late 1986, approximately 9 percent of the Canadian population owned securities individually. This figure is lower than the percentage in the United States but higher than most other developed countries.

Typically, when a corporation offers shares to the public, its shares are first traded in the over-the-counter market until the listing requirements of one of the Canadian stock exchanges are met (the Exchange Offering Prospectus procedure is an exception to this.) Private placements account for a significant portion of all the securities issues made in Canada.

b. Disclosure and Review

As stated above, primary distributions of securities to the public 6/ are prohibited unless the securities are "qualified for sale" by a prospectus or similar document. Exemptions from prospectus disclosure requirements are provided for certain transactions as specified by the provincial legislatures. In Ontario, such transactions include sales of securities to banks and certain financial institutions, sales to "exempt" (*e.g.*, sophisticated) purchasers, issues of securities in exchange for assets, limited offerings, issues of

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6/ Ontario applies its requirements to all "distributions" whether to the public or not. "Distribution" means trades in previously unissued securities, trades in previously issued securities that have been repurchased by the issuer, trades in control blocks of securities and certain trades by underwriters. Quebec, which also applies its requirements to "distributions", deems attempts to obtain subscribers for securities to be distributions.

securities in certain mergers and reorganizations, certain transactions with employees or underwriters, rights issues (although a filing of more limited information than would be required in a prospectus is made with the OSC), and distributions made through a stock exchange where sufficient information is provided through the exchange. Quebec has similar provisions, including an exemption from prospectus disclosure requirements for distributions to "sophisticated purchasers." Trades in certain securities are also exempted. In such cases offering documents are not reviewed.

The prospectus contents prescribed under Ontario's Securities Act, which would generally be accepted in the other Canadian jurisdictions, may be summarized as follows: 7/

- Name and jurisdiction of issuer;
- Description of property and business, including development of business in last five years, acquisitions in last two years, and variations in operating results;
- Information regarding directors and officers, their indebtedness, if any, to the issuer, and

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7/ Ontario's Form 12, the form of prospectus prescribed for use by industrial companies, has been used as a basis for comparison. Most of the other jurisdictions require substantially the same information (although sometimes in an abbreviated form) under different names (e.g., Quebec's equivalent is Schedule I).

their interest in material transactions;

- Names of auditors and registrars;
- Plan of distribution and distribution spread;
- Use of proceeds;
- Description of securities offered;
- Principal holders of securities, options on securities, and escrowed shares;
- Risk factors;
- Legal proceedings;
- Prior sales of securities and statement of whether market exists for securities;
- Asset and earnings coverage; and
- Inter-corporate relationships.

Financial statements required in prospectuses are as follows:

- Consolidated income statements for each of last five fiscal years and any part of current year;
- Consolidated statement of surplus for each of such completed fiscal years or part years;
- Consolidated statement of changes in financial position for year covered by income statement;
- Consolidated capitalization table; and
- Consolidated balance sheet not more than 120 days old.

Segment reporting is required and disclosure requirements do not differ greatly from United States requirements, insofar as regular debt or equity offerings are concerned. Much less disclosure may be required in certain circumstances, such as rights offerings. Forecasts are permitted.

Several provinces have adopted a system of integrated disclosure, known as the Prompt Offering Prospectus ("POP") system. 8/ Under the POP System, senior issuers who meet certain requirements including the filing of certain information with the securities commission over a period of 36 months, non-default on debt obligations, and aggregate market value of common stock, may file short-form prospectuses that incorporate by reference the issuer's current Annual Information Form. This form contains substantially all the material that would be included in a prospectus and is filed annually with the relevant securities commission. The short form prospectus must update all information contained in the Annual Information Form. Its principal distinguishing features

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8/ Provision is made for short form prospectuses in Quebec and the Uniform Act provinces (although special rulings must be obtained for access to the POP system in Manitoba and Saskatchewan). Other provinces may accept short form prospectuses prepared in accordance with Ontario's requirements, provided the material incorporated by reference is filed in their jurisdictions.

are much briefer descriptions of the issuer's business and significantly less financial disclosure.

Substantive review begins when a preliminary prospectus is filed with the relevant local securities authority. The preliminary prospectus may be used to solicit expressions of interest. It must contain certificates signed by its CFO and CEO, by two directors, by the underwriter and by the promoter, if any, representing that full disclosure of all facts relating to the securities offered thereby is included. It must be accompanied by certified copies of resolutions of the issuer's board authorizing the prospectus, an auditor's comfort letter (if financials are not included in the preliminary prospectus) and geologists' reports on any material natural resource properties. Material contracts and experts' consents may be filed with either the preliminary or the final prospectus.

Once concerns have been raised and resolved, a final prospectus may be filed and distribution may commence upon issuance of a receipt for the prospectus. Not all offering documents are reviewed by the relevant securities commission. The OSC, for example, does not review the offering document used in exchange offers.

The Securities Act of Ontario expressly empowers the OSC to make certain qualitative judgments on the merits of the securities to be offered by a prospectus. Approval will be refused if the prospectus does not meet the disclosure requirements of the Securities Act. Approval will also be

refused if, in the opinion of the director of the OSC, the resources of the issuer are insufficient to accomplish the purpose of the issue as stated in the prospectus, if the issuer cannot be expected to be financially responsible, if there are grounds for believing that the issuer's business will not be conducted with integrity, or if any person or company preparing part of the prospectus is unacceptable. The director may also refuse to approve a prospectus if the director thinks it is not in the public interest to do so.

Similarly, Quebec's director may refuse approval "if the protection of investors requires it." Power to refuse approval of a prospectus is possessed by most of the other local securities authorities under their respective statutes. Saskatchewan, for example, may refuse approval where an "unconscionable" consideration is given for promotion purposes or for the acquisition of property. When concerns are raised about an issuer or its business, it is more likely that additional disclosure, disclaimers or warnings will be required by the reviewing commission rather than that a receipt for a prospectus will be refused outright.

Any person affected by a decision of the director in Ontario is entitled to a hearing and review by the OSC. A decision of the OSC may, in turn, be appealed to the Divisional Court of Ontario. There is, however, a reluctance on the part of the Canadian courts to review regulatory compliance matters in the securities field and deference is paid to the decision

of securities administrators. The decision of a securities commission is therefore unlikely to be overturned.

c. Listing Requirements

Issuers apply to the appropriate stock exchange for listing of securities. On the TSE, for example, formal approval is granted by the Stock List Committee. Where a company is going public at the same time as it applies for listing, formal approval on a conditional basis is given, and the applicant must meet the TSE's listing requirements (such as shareholder distribution) upon completion of the public offering.

Each exchange has different listing requirements, which may vary according to an issuer's industrial sector. Listing requirements focus on the capitalization (size of assets or profitability) of the company and the size of its public shareholding. The TSE requires, for example, that a class of securities for which listing is sought be distributed among at least 200 public shareholders, and that the aggregate market value of such securities be at least C$350,000 (currently about US$253,000). Operating companies must show pre-tax profits and emerging companies must have substantial assets and sufficient working capital.

6. Secondary Market

Prospectuses are generally not required for secondary trades (unless, for example, a block of securities representing control of an issuer is traded or the primary distribution was made pursuant to an exemption from the prospectus requirements).

Once an issuer has made an offering of securities, it is obliged to make ongoing, timely disclosure of all "material changes." Reporting issuers must prepare and file with the appropriate securities commission comparative quarterly interim financial statements within sixty days (45 in Quebec) of the end of the quarter, and annual audited comparative financial statements within 140 days of the fiscal year end (90 in Quebec). These statements must be distributed to shareholders.

The stock exchanges' continuing disclosure requirements generally reflect the requirements imposed by the provincial authorities. Issuers who make use of the POP system file Annual Information Forms as described above.

7. Liability

Under the Ontario and Alberta securities acts, civil liability for misrepresentations in prospectuses falls on issuers, selling security holders, directors, underwriters, persons who have given consent to the inclusion of reports by

them in the prospectus (in respect of such reports only) and any other person signing the prospectus. 9/ Purchasers of securities are deemed to have relied on such misrepresentations. No liability rests with persons making representations in the prospectus that they believed to be accurate after reasonable investigation, or who previously withdrew their consent to the filing of the prospectus or to the inclusion of such representations.

Quebec imposes liability for misrepresentations upon the issuer or selling security holder, the issuer's senior executives and the dealer through whom such securities were distributed. The defendant is liable for damages unless it can be shown that the defendant acted with prudence and diligence (except where the issuer or selling security holder is the defendant) or that the plaintiff knew of the alleged misrepresentation. 10/

Under the federal Canadian Criminal Code, Part VIII, Sections 338 and 339, it is an offense to use the mails to defraud. This provision has been applied to fraud in prospectuses. Under most provinces' securities acts, any person who makes a misrepresentation in a prospectus is guilty of an offense and subject to a fine and in the case of an

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9/ Section 126, Ontario Securities Act; Section 168, Alberta Securities Act.

10/ Sections 218-220, Quebec Securities Act.

individual, to imprisonment. 11/ Every director or officer of a company who authorized, permitted or acquiesced in such offense is also guilty of the offense and subject to the same penalty. In Ontario, no person can be convicted if he proves that he could not, with reasonable diligence, have known that the statement in question was a misrepresentation.

8. Rating System, Withholding Tax, Limitations on Transferability

There are two bond rating services, the Canadian Bond Rating Service (the "CBRS") and the Dominion Bond Rating Service, Ltd. Both agencies rate domestic commercial paper and corporate bonds. Ratings may vary considerably between agencies. The CBRS also rates governmental issues, which usually are rated in the highest categories.

A standard 25 percent withholding tax is generally applied to dividends and interest, although there are some exceptions, especially in the case of bond interest. Most government and treasury securities and recent long-term corporate bonds are exempt from withholding tax. Withholding tax is reduced to 15 percent for investors in certain countries with which tax treaties exist.

11/ Section 81, Ontario Securities Act; Section 161, Alberta Securities Act; Sections 196, 197, and 202, Quebec Securities Act.

Regulations administered by the Foreign Investment Review Agency were developed to prevent the control of certain Canadian businesses by foreigners. Thus foreigners are restricted in their acquisition of shares issued by companies in, among others, the banking, energy and communications businesses and, until recently, the securities business in Ontario.

Canada has no exchange controls restricting capital movement.

E. FEDERAL REPUBLIC OF GERMANY

1. Description of Statutory Scheme and Regulatory Authority

The West German securities market is relatively unregulated compared to those of most other developed countries. There is no central supervisory body that oversees securities trading. The regulation that does exist is exercised principally over the stock exchanges, leaving trading off the exchanges comparatively unregulated.

Germany has a federal legal system and a federal statute governs the securities market. Pursuant to the Stock Exchange Act, 1/ the governments of the states (or "Länder") are given jurisdiction over the establishment and supervision of stock exchanges in their states. The states appoint commissioners for this purpose. Commissioners attend meetings of the stock exchange supervisory bodies but do not intervene in their operations. There is little federal supervision of the exchanges and, to a large degree, the stock exchanges are self-regulatory. The Stock Exchange Act gives the exchanges jurisdiction over the fixing of prices, the admission of securities to listing, membership of the exchange and the prevention of fraudulent manipulation of securities prices. The exchanges also regulate securities professionals. In

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1/ The Borsengesetz of 1908, as amended. Several decrees and administrative orders relating to the securities market have also been issued by the federal authorities.

order to be licensed, brokers (who perform a more limited function than do brokers in the United States) must meet the exchanges' requirements for personal reliability and professional competence. However, professionals are not subject to the same degree of self-regulation as in the United States.

There are no restrictions on banks' activities in the securities field. Banks obtaining banking licenses may participate freely in securities transactions. No distinctions are made between investment and commercial banks, and all banks may underwrite offerings of securities. Banks also function as intermediaries, accepting brokerage orders from the public; therefore, brokers such as those common in the United States do not exist.

The principal sources of prospectus disclosure requirements are the Stock Exchange Act and the Notification of Admission of Securities based thereon (the Zulassungsbekanntmachung or "ZulBek"). The ZulBek is a Federal Implementing Order issued in 1910. It sets out the duties of the stock exchanges' listing committees and the standards to be applied by them. The provisions of the Stock Exchange Act reflect EEC requirements relating to exchange-traded securities.

The Stock Exchange Act and the ZulBek cover only "official" trading on a stock exchange. Trades made off the exchanges are subject to minimal regulation. Parts of other

statutes relating to the operations of issuers engaged in particular businesses also effect the manner in which such issuers may distribute assets. 2/

Because the Stock Exchange Act is applicable only to exchange-listed securities, there is a considerable discrepancy between the extent of regulation of securities transactions made on an exchange, and those made on the "unofficial" market. While the regulation to which exchange-traded securities are subject is extensive (although not as extensive as that of the United States), trading off the exchanges is virtually unregulated. Only for investment funds has a detailed system of control been instituted. 3/

Since Germany has no system of registration and because its prospectus requirements apply only to securities listed on a stock exchange, securities offerings made abroad, whether or not by German issuers, and whether or not to German nationals, are not subject to regulation.

2/ See, e.g., the Stock Corporation Act (Aktiengesetz), which regulates the affairs of stock corporations and partnerships akin to United States limited partnerships, and also imposes periodic reporting requirements. Mutual fund distribution is regulated by the Investment Company Act. It does not cover foreign investment companies, which are subject to the Foreign Investment Companies Act.

3/ Investment funds are governed by the Investment Company Act or Gesetz uber Kapitalanlagegesellschaften of 1957 (the "KAGG").

2. Nature of the Securities Markets

There are eight regional stock exchanges in Germany. 4/ Frankfurt is the most important of these, accounting for about 50 percent of the total turnover on all exchanges. Düsseldorf accounts for a further 30 percent. There are some differences among the practices of the various exchanges. In several cities the stock exchanges are private associations, while in others they are organized by the local chamber of commerce. Two types of dealing take place on the exchanges: "official" and "regulated unofficial" dealing. Officially-listed securities are the only securities for which prospectuses must be produced. The securities of larger companies, government bonds and foreign issuers are officially listed. Transaction prices are published in the Official List and in the press.

4/ These are Berlin, Bremen, Düsseldorf, Frankfurt, Hamburg, Hanover, Munich and Stuttgart. In 1987, the Arbeitsgemeinschaft der Deutschen Wertpapierbörsen, a body representing the interests of these stock exchanges, was created.

Listing requirements are set by each exchange. 5/ Official prices are set by the Kursmaklers. 6/

"Regulated unofficial" dealing takes place on the exchanges between banks and/or Friemaklers. 7/ Listing requirements are less onerous than for official dealing. Smaller companies' securities are traded by this method. Prices are published by the Friemaklers. The regulated unofficial market on all stock exchanges is subject to oversight by a supervisory body established by the eight exchanges.

Unregulated unofficial dealing takes place off the exchanges with unlimited hours. Trading may be literally over-the-counter (many banks will exchange bearer securities

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5/ In order to be listed on the Frankfurt Stock Exchange, the par value of securities to be listed must total at least DM 500,000 (currently about $250,000) (where shares have no par value, at least 1,000 must be listed), the company must have been in business continually and successfully for five years and have a dividend record, and the number of shares available for stock exchange trading should be sufficient to guarantee the proper determination of share price.

6/ Kursmaklers are official brokers who arrange transactions between members and are responsible for the daily setting of prices. They concentrate on securities within specific industry sections.

7/ Friemaklers or unofficial brokers engage primarily in "unofficial" trading among members. Banks, which are also members of the exchanges, provide the link between the public and the stock exchange floor.

for cash) or by telephone. Prices are published by Friemaklers and in private newsletters. Anyone may buy and sell securities in this market, subject to no supervision or disclosure requirements. There is no requirement that trading in listed securities be confined to the listing exchange, and thus all securities may be purchased in the unregulated unofficial market.

A fourth market segment, the "geregelte" or "regulated" market was established in May 1987. The government hopes to encourage medium-sized companies to go public on this market, which is comparable to London's Unlisted Securities Market. Listing on the geregelte market is cheaper to obtain than on the official market, but more disclosure will be required than in the unofficial markets. It is expected that this market will ultimately replace the regulated unofficial market.

3. Issuers

Not all potential domestic issuers make use of the German securities markets. Many larger companies find that fixed-interest bank loans provide capital at more advantageous rates than do bond issues. Equity issues are similarly disfavored. 8/ Since 1983, however, companies have been coming

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8/ Even of those companies issuing securities publicly, a limited number apply for listing. Some 3000 public companies exist in Germany, only 451 of which had an official listing at the beginning of 1986.

to the securities markets in increased numbers. In addition to corporations, non-government issuers include mortgage and commercial banks and other financial institutions.

Foreign issuers make use of the German markets; they often list their securities on the stock exchanges for public relations purposes. Some foreign issuers prefer to raise capital in the unofficial markets by private placements, although official estimates show that foreign issuers prefer the official to the unofficial markets. The number of securities offerings in Germany made by foreign issuers has increased in recent years.

The federal government issues long- and medium-term bonds, as do federal agencies such as the post office and the railways. States, municipalities and cities also issue debt securities.

As of the beginning of 1986, there were 628 companies with equity shares listed on the German stock exchanges. Foreign companies accounted for 177 of this total. Of the listed companies, 15 were newly authorized in 1985 to list their equity on the German stock exchanges, with seven of these being foreign issuers. There were new listings in 1985 of bonds and debentures totalling DM 233 billion ($79,097.2 million), compared to listings of DM 133 billion ($47,293.8 million) on the German stock exchanges in 1984. The domestic private

sector accounted for DM 126 billion ($42,849.7 million) of the 1985 total, the domestic government for DM 70 billion ($23,593.2 million), and DM 37 billion ($12,654.3 million) were international bond issues. 9/

4. Types of Securities Traded

Corporate bonds and equities are available, but not actively traded. Less than 0.5 percent of all corporate financing is raised through the issue of shares. 10/ Most equity securities are common shares with voting rights. Disproportionate voting rights are generally not found in securities of the same class. Preferred shares, which carry no voting rights, may be issued. Warrants carrying the right to equity securities are available, as are certificates of participation, which provide participation in profits with no voting rights. Both debt and equity securities are generally in bearer form although partly paid shares must be in registered form.

Corporations may raise capital easily through bank borrowing or through the issuance of debt certificates known as

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9/ International bonds include Eurobonds and foreign bonds.

10/ Turnover in equity securities is increasing more rapidly than in debt securities however.

schuldscheindarlehen, which are not legally classified as securities. These certificates are not listed on an exchange; however, they are traded in a large and active over-the-counter market. Government and bank bonds are the most important element of the German securities market. Most of these are fixed-interest bonds, since floating rate notes were not permitted until 1985.

The so-called "gray" (unregulated unofficial) market is dominated by different kinds of mutual funds, tax loss companies, "public limited partnerships" (which provide tax shelters) and real estate investment trusts. The market in such securities is relatively illiquid.

5. Primary Offerings

a. Participants in a Distribution

Most offerings of securities, whether on the official or unofficial markets, are made through banks. When an issuer intends to offer securities, it contacts a bank which forms a syndicate for sale of those securities. The bank will also act as a sponsor if official listing on an exchange is to be sought for the securities. Syndicate members may act as selling agents or as underwriters.

There are a variety of issuing procedures, but in general public sector bonds are sold through a banking consortium,

while private sector bonds are sold directly to the market by the issuing institution without the use of a consortium or intermediary.

Authorization must be obtained from the monetary authorities prior to issue of private bonds. The Capital Market Committee, which comprises representatives of the major issuing houses, consults with the German Federal Bank (the "Bundesbank") on the timing and volume of new issues to ensure an orderly capital market through adoption of a voluntary issue calendar.

All securities are offered to the public through publication of prospectuses in newspapers. There are no restrictions on advertising of any securities, and banks often additionally send offering material directly to their customers by mail. Completion of distribution, including listing, takes about three to four months.

Prospectus requirements derive from listing applications rather than from the nature of the offering. There is no particular legal distinction between public and private issues. Despite the relative absence of regulation, most equity issues are made by private placement rather than by advertisement to the general public.

Individual security holdings are increasing, but Germans are traditionally wary of the stock markets. Nevertheless, individuals, albeit a relatively small number of wealthy investors, make up a large proportion of the investor base,

either directly or through mutual funds. Institutions such as pension funds also participate in the market; however, these are often subject to limitations on the type of investments they may make. Foreign investors, principally from Switzerland, Britain, the United States, and Arab countries, play a large part in the market, especially in debt securities.

b. Disclosure and Review

The Stock Exchange Act requires publication of a prospectus prior to listing. No prospectus or equivalent document need be published before a security is traded in the regulated unofficial market although a memorandum summarizing the business position of the issuer must be submitted to the "Committee for Trading Securities Not Officially Listed" prior to trading on the regulated unofficial market. 11/

Prospectuses are not required for securities issued by federal or state government agencies, nor are they required for other issuers if a prospectus has been published within twelve months prior to application for admission of additional securities in which case the issuer need publish only a "notice of referral." Such notice contains all the principal data required in a prospectus, and indicates material changes since

11/ Although prospectuses are not required, certain minimal information regarding the issuer must nevertheless be disclosed to potential investors.

the date of the last prospectus. It may simply make reference to the financial statements in the last prospectus unless more recent financials have been published, in which case they must be included. Prospectus requirements may be reduced where application is made to list securities already listed on another exchange. With respect to securities traded on the "gray" market, disclosure of information is solely at the promotor's discretion.

Information to be provided in prospectuses covers:

- Name of issuer, registered office, purposes, and in the case of offerings of equity securities, its directors and supervisory board, fiscal year and manner by which notices are given to the public;
- Use of proceeds of the offering;
- Value of securities, amount, series numbers and nature of certificates;
- Rights of securities as regards terminability, redemption (more detailed information regarding rights of securities is required when equity is issued) and rights of the issuer's other securities;
- Security or collateral for debt securities;
- Interest rate, when interest or dividends are payable, deductions or restrictions on payment of dividends or interest;
- Dividend history for the last five years;

- Financial liabilities not apparent from the balance sheet;
- Latest financial statements (no older than 13 months), with explanation of balance sheet items relevant to the issuer's economic position;
- Turnover for the last three years;
- Recent negative developments; and
- Rights of any third party to acquire the issuer. 12/

By law, an investment company's prospectus, which must be furnished to each investor, must provide specific information as to the company's investment policies, terms and time schedule of inventory statements, the company's management fee, the redemption price of the securities and a current list of the company's holdings. 13/

Both the prospectus and the listing application must be published in the Financial Gazette and at least one other principal newspaper. Prospectuses are not reviewed by any

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12/ A "Working Paper," which contains all requirements for the layout of prospectuses and listing, is used by German securities professionals. It is not publicly available. "Working Paper for the Listing Committees at the Stock Exchanges of Berlin, Düsseldorf, Frankfurt am Main, Hamburg, Hanover, Munich and Stuttgart," Spring 1966, status juris: 1974.

13/ Investment funds are governed by the Investment Company Act or Gesetz uber Kapitalanagegsellschaften of 1957 ("KAGG").

regulatory body other than the listing committee of the stock exchange where the securities are to be listed. The draft prospectus must be filed together with copies of the issuer's constitutional documents and other documents relating to the issuer's current liabilities and any litigation or recent material developments.

Although the listing committee is required to ensure that the prospectus is complete, it does not guarantee the accuracy of any information contained in it. The purpose of the listing committee is to ensure that sufficient factual information is given to enable investors to evaluate the securities to be listed. 14/ An application for listing that fulfills the legal requirements cannot be refused unless the public interest would be harmed or admission would "give rise to a deception of the public." The latter allows the listing committee to refuse admission to securities of issuers in financial trouble or grossly overvalued securities. The decision to refuse admission can be appealed to an administrative court.

Repeat issues of securities can be made within a year of issue of a prospectus by a "reference prospectus" which includes essential information about the issuer and its management, details of economic and financial developments and

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14/ Securities traded on the regulated unofficial market undergo a comparable review process, but are subject to less strict disclosure requirements.

the latest annual financial statements. Other information is incorporated from the original prospectus.

6. Secondary Trading

Trading on the exchanges can only be executed by using a bank represented at the relevant exchange. Securities dealing is dominated by banks, which have a legal monopoly on dealing. The largest of the banks are represented at several exchanges.

Continuing disclosure requirements depend on the nature of the issuer and whether its securities are listed. Listed companies subject to the Stock Corporation Act are required to publish annual financial statements and a report by management both in the Federal Gazette and a stock exchange gazette. Financial statements must be audited, and their content is prescribed in detail. Other entities have similar reporting requirements. Investment companies are required to disclose details of their securities holdings twice a year. 15/ Requirements of the EEC Directives on financial reporting are expected to be incorporated into German law shortly.

Issuers of all listed securities (whether or not subject to the Stock Corporation Act) are required by the Stock Exchange Act to undertake, during the period that their securities are listed, to publish notices, annual financial

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15/ KAGG Section 25.

statements and resolutions as to distribution of dividends in the Federal Gazette. In the case of equity or convertible securities there is an additional requirement for publication of this information in at least one stock exchange journal. Financial statements are not required by the Stock Exchange Act to be audited.

7. Liability

Liability for the accuracy and completeness of the information in the prospectus for officially listed securities rests with the issuer and with the banks that are instrumental in listing the securities. These persons are liable to investors for damages proved to have been the result of inaccurate statements made with intent or through gross negligence. 16/ Actions for recovery of such loss are, however, not common. More protection is provided for investors in mutual funds. Under the Investment Company Act, liability

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16/ Section 45, Stock Exchange Act. This section only applies to loss occasioned by reliance on a prospectus that is already published. If, as is common, rights are taken up prior to the publication of the prospectus (German banks often offer rights to securities as yet unissued), the Stock Exchange Act provides no protection against misstatements. Prospectus liability for investment companies is governed by KAGG Section 20, which affords more investor protection in that, unlike the Stock Exchange Act, the burden is not on the investor to prove the issuer's failure to provide accurate information.

for prospectus misstatements is extended to professional dealers neglecting to exercise due diligence.

The Penal Code imposes penalties upon persons damaging another person's financial position by fraudulent misrepresentation. The Stock Exchange Act also provides for criminal penalties for any persons issuing incorrect information in a prospectus or other public announcement with the object of obtaining subscriptions to or purchases of securities. 17/

8. Rating System, Withholding Tax, Limitations on Transferability

There are no domestic rating agencies in Germany similar to those in the United States.

A 25 percent withholding tax on interest and dividend payments on domestic DM-denominated securities was repealed in 1985. A turnover tax of 0.25 percent (0.1 percent for public and certain other bonds) is imposed upon transfer of securities. The government promised in 1987 to abolish this turnover tax.

There are presently no restrictions on foreign ownership of securities, and in 1986, foreigners accounted for more than half the sales of all securities in Germany. Historically,

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17/ Section 88(1), Stock Exchange Act.

however, the government's attitude towards foreign investment has been encouraging or restrictive as necessary to support the DM.

F. FRANCE

1. Description of Statutory Scheme and Regulatory Authority

a. Source of Regulation

France's scheme of securities regulation is supervised by the Commission des Operations de Bourse (the "COB") and the Chambre Syndicale des Agents de Change (the Stockbrokers' Council or "Chambre Syndicale"). Securities may not be offered and sold publicly by most issuers 1/ in France without approval of the COB. Where securities are to be listed on a stock exchange or traded on the over-the-counter market, approval of both the COB and the Chambre Syndicale is required. The Treasury Department of the Ministry of Economy supervises, *inter alia*, exchange control, cross-border investments and securities markets, and coordinates large offerings and the issue of foreign securities. The COB, an independent regulatory agency, was created in 1967. It consists of a chairman appointed for a four-year term by the Council of Ministers (the Cabinet), four members appointed for four-year

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1/ The original legislation applied only to companies limited by shares but was subsequently expanded to cover investment companies and real estate investment companies. Although few such exist, issuers with a different form of corporate organization would not be subject to disclosure requirements. Similarly, although few bonds are issued by borrowers other than companies, such issuances are not subject to COB supervision at the time of issue, but only upon application for stock exchange listing.

staggered terms by the Finance Minister, and a government representative, together with a full professional staff.

The COB's purpose is to protect investors by, among other things, requiring disclosure of adequate information and ensuring the proper function of the financial markets. To this end, it regulates the information given by issuers to their security holders and the public in general. It also oversees such matters as the disclosure of acquisition of control by security holders and the operations of the stock exchanges. Additionally, the COB processes complaints regarding the operations of the securities markets, and regulates insider trading, which is illegal.

The body of disclosure requirements administered by the COB is found in various laws passed by parliament, decrees implementing such laws and administrative orders. Provisions relating to exchange-listed securities are based on the requirements of EEC Directives. Trading on the stock exchanges is limited to stockbrokers ("agents de change"), who may buy and sell only for clients, and not for their own account. All stockbrokers belong to a self-regulatory organization, the Compagnie des Agents de Change ("CAC") whose regulations are legally enforceable by the Finance Minister and are subject to approval by the COB. The CAC regulates examinations of agents de change and oversees their capital requirements.

Agents de change, whose numbers are limited by law, are licensed by the Finance Minister after passing professional

examinations and meeting the approval of the Chambre Syndicale. There is no direct government regulation of stockbrokers, although the COB supervises the activities of auditors, investment advisers and "remisiers" (intermediary brokers).

CAC members elect the members of the Chambre Syndicale. Its powers and organization are determined by governmental decree. 2/

b. Scope of Regulation

While the filing and disclosure requirements for all public issues are similar to those in the United States, the requirements apply only to certain types of issuers and only to sale of securities for cash. A sale of securities by certain issuers, 3/ or by any issuer for consideration other than cash, is not subject to the regulatory system. The regulation of securities professionals is also similar to the United States system, although supervision is somewhat less strict.

The investigative powers of the COB are limited to the activities of companies publicly offering their securities in

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2/ The Decree of October 7, 1980 (as amended) is the principal enabling law.

3/ *See* discussion in n.1, *supra*.

France. 4/ Offers made outside the French markets, whether or not to French citizens, are not subject to regulation.

2. Nature of Securities Markets

France has seven stock exchanges, located in Paris, Bordeaux, Lille, Lyon, Marseilles, Nancy and Nantes. The Paris Bourse (Stock Exchange) is, however, clearly dominant, with some 98 percent of all trading in listed securities being conducted there. The regional stock exchanges tend to trade securities of local interest only. Each stock exchange comprises three different markets: the official stock exchange, the second market and the over-the-counter market. These are described more fully below.

By law, a given security may be traded only on one market. Listed securities must thus in principle be traded only on the stock exchanges, although off-exchange trades are allowed in certain cases, subject to approval of the Chambre Syndicale if a stockbroker is used. An example of such a case would be a transaction between companies of the same affiliated group, or between two individuals "who know and have confidence in each other". The issuer of a security must give its approval for

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4/ Regarding the concept of a public offering, see discussion accompanying n.11, infra.

block transactions in that security to be consummated off the exchange.

The COB decides whether a company should be admitted to the Paris or regional exchanges, taking into account the location of the company's activities and the expected market for the shares being listed. Admission requirements for the regional exchanges are similar to those of the Paris Bourse, with reduced requirements in such qualification categories as the minimum number and market value of the issuer's securities.

The Paris Bourse is the sixth largest market in the world, with a market capitalization of approximately FFr 2,162 billion (currently about $335 billion), approximately 30 percent of which is equity. 5/ In order to list on the Paris Bourse, the Chambre Syndicale requires a company to have had profits and have paid a dividend in its last three fiscal years. The estimated market value of the company's shares should be "adequate." Although there are no fixed criteria to determine in practice what is meant by "adequate," a minimum value in the range of FFr 200 to FFr 300 million (currently about $30 to $46 million) is usually required. The COB requires that at least 25 percent of the share capital be offered for sale to the public and that the share capital consist of at least 320,000 shares. Foreign companies are subject to the same

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5/ 1986 OECD figures.

requirements, except that there is no fixed minimum number of shares.

Securities listed on the official stock exchanges are quoted either on the marché du comptant or on the marché à règlement mensuel (previously the marché à terme). Securities quoted on the marché du comptant are generally delivered and paid for at the time of the transaction. This differs from the usual practice regarding securities quoted on the marché à règlement mensuel, where, at the time of a transaction, the seller and purchaser of the securities generally agree to tender the securities and the agreed consideration at a fixed date in the future.

The Second Marché, or second-section market, was created in 1983 to provide access to the capital markets for medium-sized companies. Listing requirements on the second-section market are less onerous than those of the Bourse, and the market acts as a testing ground for companies that intend to apply for full listing at a later date. As of the end of 1985, about 130 securities, four of which were foreign, were listed on the second-section market. Aggregate market capitalization is about FFr 60 billion ($7.9 billion).

Liquidity in the second-section market is good as the banks responsible for bringing issuers to the market are obliged to maintain markets in those issuers' securities. The second-section market is attractive to family-owned companies wishing to raise capital but not wishing to comply with the

requirements for full listing. For example, the second-section market requires that only 10 percent of a company's capital be distributed to the public, while the Bourse requires that 25 percent of the listed company's capital be distributed to the public.

The over-the-counter market ("marché hors-côte"), exists for securities not listed on the "marché officiel" (i.e.- the main section of the exchanges) or on the second marché. Liquidity on the marché hors-côte is poor. Volume in this market is much smaller than on the official exchanges, especially in Paris, where it is very limited.

3. Issuers

Government as well as private agencies issue debt and equity securities. A number of foreign issuers, principally British, United States and Japanese, have introduced securities to the French markets, and eleven of the fourteen new equity issues listed in 1985 were by foreign companies.

As of the beginning of 1986, there were 678 companies with equity shares listed on the Paris Bourse. Foreign companies accounted for 189 of this total. There were new listings in 1985 of bonds and debentures totalling FFr 311 billion ($39,366.4 million), as compared with listings of FFr 232 billion ($24,741.1 million) on the Paris Bourse in 1984. The domestic private sector accounted for FFr 70 billion ($8,930.5

million) of the 1985 total, and the domestic government for FFr 240 billion ($30,435.9 million).

4. Types of Securities Traded

For a variety of reasons, the most important being favorable banking regulations, companies have historically preferred to borrow from banks when seeking new capital, rather than to issue securities. The securities market in France is therefore small compared to the country's industrial base. The securities market has improved significantly in recent years in terms of turnover and liquidity, 6/ however, and the range of securities available in the French markets is nearly as wide as that in North America. New debt and equity instruments have been devised in order to attract all kinds of investors. This is due to recent legislation which has enabled companies to issue many new types of securities so long as certain minimal requirements are met. 7/

In terms of capital value and turnover, the debt market is about four times larger than the equity market. Although trading in both is increasing, tax considerations and issuers'

6/ Liquidity has been promoted by government restriction on French persons' investment abroad.

7/ Law Nos. 83-1 of 3 January 1983, and 85-1321 of 14 December 1985.

aggressive pursuit of the longer-term debt market have resulted in the more rapid increase of debt security trading. An interesting feature of the French market is the availability of index-linked bonds. 8/

Other securities available include interests in mutual funds. French investors have access to over 2,000 funds, the number of which has increased dramatically over the last five years. They are managed by banks and stockbrokers. Assets held by mutual funds totalled over FFr 194,121 million ($26 billion) as of December 31, 1985. Options are available and traded on many securities. A formal market for traded options was introduced in 1986. Preemptive rights issues are common on the Paris Bourse.

The current deregulation of the French financial markets has led to the introduction of new securities such as non-voting preferred shares and subordinated certificates of indefinite maturity. 9/ A limited form of disproportionate voting rights (shares with double votes) is permitted under certain circumstances. Attempts are also being made to widen

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8/ These bonds, the redemption and/or interest payments of which are linked to the value of other monetary indices, such as gold or the value of the European Currency Unit, provide useful protection against the effects of inflation and the weakness of the French franc.

9/ These are the functional equivalent of non-voting equity participation securities.

access to short-term debt securities for investors other than financial institutions.

Bearer securities are popular because of the anonymity they provide. Debt securities are usually issued in bearer form, although registered bonds are also available. Equity securities are available in both registered and bearer form.

5. Primary Offerings

a. Participants in a Distribution

The distribution of securities is usually carried out by a bank or banks appointed by the company. Such banks normally act as selling agents only, not as underwriters. Banks, whether investment or retail, are not restricted from securities activities, and are an important link to French brokers.

The terms and conditions of each issue are set by joint agreement between the issuer, lead manager and the Treasury Department a few days before the official opening of the issue. The banks prepare and co-sign the company's prospectus. The distributing banks make the offering to the public and to institutional investors (such as insurance companies and pension funds) as well as to other financial institutions. Distribution to the public (usually wealthy private customers)

is done by the banks through their own branches, and through brokers. 10/

Public advertisement is permitted only when specific approval is obtained. Notice of a public offer must generally be inserted in the official legal bulletin, however. Stock Exchange quotation occurs the day before the issuer receives the proceeds of the offering, which is usually about two to four weeks after the official opening of the issue.

b. Disclosure Requirements

The type of disclosure to be made by an issuer and the review to which that disclosure is subject depends on whether the securities being issued are to be offered publicly and whether a stock exchange listing or hors-côte trading is to be sought for them. A prospectus approved by the COB is required before any securities, domestic or foreign, may be offered to the public. 11/ A file with information about the issuer's

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10/ France has a low percentage of individual share ownership. Only 1.5 million people out of a population of over 55 million hold shares. Debt security ownership is more comparable to other industrialized countries. Additionally, around 5 million people own shares in mutual funds.

11/ Articles 6 and 7, Order 67-833 of Sept. 28, 1967. The law characterizes as a public offering that which satisfies any of the following criteria: (1) the securities issued by the company are admitted to the official stock exchange quotation, (2) the company (continued . . .)

business and prospects, and a copy of the draft prospectus are sent to the COB and, when listing of the securities is sought, to the Chambre Syndicale as well. Additionally, any offerings of securities by foreign issuers and those by domestic issuers for amounts above FFr 15 million (currently about $2 million) must be approved by the Finance Ministry. In such a case, the Finance Ministry will consult the COB prior to approval of the securities.

The prospectus must be given to any person invited to subscribe for securities. 12/ Prospectuses, the contents of which are prescribed by a COB Instruction of February 2, 1982 (the "COB Instruction") cover the matters set out below. It should be noted that the COB Instruction provides guidelines rather than a format which must be followed strictly, and that prospectuses for second marché, hors-côte or unlisted

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(. . . continued)
sells its securities through the services of banks or related establishments, or stockbrokers, or (3) the company advertises, in any way, the securities it wishes to sell. (Arts. 71 and 72, 1966 Act). These criteria are not exhaustive, and the COB assumes an offering is public unless proved otherwise. Only certain companies that issue shares (sociétés par actions) are permitted to make public offerings.

12/ Prior to 1967, disclosure was limited to a requirement that details of the issue be published by a "statutory note" in the official gazette. The statutory note has lost a great deal of importance since 1967, but the requirement has been retained. One of the reasons for this is the desirability of centralizing all company announcements in one publication.

securities tend to be shorter and less detailed than those for securities listed on the marché officiel. 13/

Prospectuses for all securities must include the following information:

- Corporate resolution concerning issuance of securities, offering price;
- Information concerning shares including number, par value, class, rights to current earnings, exercise of pre-emptive right, period open for subscription, banks where subscription can be made;
- Information concerning debentures including dates at which is interest payable, interest rate, effective return to subscriber, amortization, repayment, taxation, guarantees, paying agents and details regarding conversion;
- Costs of issue and net proceeds;
- Name, registered office, term of existence, corporate form of issuer, any applicable special statutory provisions, where documents are available;
- Fiscal year, allocations of profits, general meetings, restriction on sale of shares and any other special characteristics;

13/ Art. 112, Règlement Générale de la Compagnie des Agents de Change.

- Capital structure, types of shares issued, convertible debentures, if any, treasury or "founders" shares, changes in capital over past five years, approximate number of shareholders, shareholders owning over five percent, holdings of management;
- Issuer's activities, a brief history, existence of group, if any, number of employees, place of business, principal investments in last 5 years, sources of supply, research and development, types of activity, brand names, volume of sales over 5 years by line of business and with percentage changes, customers and markets, exceptional events and litigation, subsidiaries, and, if the company is part of a group of companies, information must be given regarding the parent, if applicable;
- Management, names and duties of directors and principal officers, and profit sharing and stock options;
- External auditors;
- Recent changes and prospects of issuer;
- Purpose of the issue; and
- Identity of persons assuming responsibility for the prospectus.

Prospectuses for listed securities also include the following matters:

- Description and number of securities;
- Exchange where listed and date of original listing;
- Minimum offering price and justification therefor; and
- Prices on other exchanges.

Prospectuses for unlisted securities must also include the following:

- Market for the securities and return on investment.

As with many non-United States prospectus requirements, information about management is limited. Some textual discussion of industry segments is suggested.

Financial information disclosed in prospectuses covers the following:

- When the company is parent of a group, financial statements of major affiliates for last three (may go up to five) years, consolidated financial statements for last three years, chart showing consolidated source and application of funds;
- Profit and loss statements for last three years, whenever possible with results by division and comments concerning variations, impact of capital gains, if any, and brief description of computation of taxable result;

- Balance sheet for last three years, interim midyear statement and comparison with previous year;
- Non-balance sheet items such as guarantees or leasing contracts; and
- Five year chart showing source and application of funds.

Industry segment information is given "wherever possible," but geographic segment information is not required. The COB requires that issuers submit their accounts to an audit prior to issuance of securities. Audits are performed by statutory auditors authorized by the COB until such time as the COB determines that the quality of the audit carried out by issuers' regular auditors is satisfactory.

Where the securities to be issued are not to be listed, the issuer, usually through a sponsoring bank, submits certain documents to the COB. These documents will include the issuer's constitutional documents, its annual reports, descriptions of the issuer's activities, and the draft prospectus. The COB reviews prospectuses for adequacy of disclosed information, but makes no judgment on the economic soundness of the proposed investment. It may request additional disclosure to be made in the prospectus.

Upon a finding that satisfactory disclosure is made, the COB's stamp or "visa" is attached to the prospectus. The COB has the power to refuse to approve a prospectus, in which case

a very limited power of appeal is allowed to the Council of State. The COB does not, however, generally refuse to approve prospectuses, but instead requires amendment of the disclosures made therein.

Where securities are to be listed on a stock exchange 14/ or traded on the marché hors-côte, both the COB and the Chambre Syndicale must approve the issue. The issuer files with the Chambre Syndicale the same documents as filed with the COB, plus a listing application. Approval for the issue of listed securities may take up to five months.

Continuous issuers are often authorized upon application to the COB to use an abbreviated form of prospectus if, in the opinion of the COB, the company generally discloses adequate financial information, such as timely filing of its annual reports, which contain such information. The COB has also allowed under limited circumstances a summary prospectus or "note abregé" to be distributed to investors where a full formal prospectus may be too technical to be understood readily, although the full prospectus must be made available to investors upon request, and sent to securities professionals.

14/ Disclosure requirements and the review process are the same whether application is made for full or second-section listing.

6. Secondary Market

a. Participants

Nearly all securities transactions require the intervention of a stockbroker. More than 75 percent of all securities orders are transmitted to brokers through banks. 15/ The banks also provide services to investors such as safekeeping, collection of dividends and interest, portfolio advice and provision of mutual funds. It is estimated that 50 percent of securities trading is by institutions, and that foreign investors account for 20 percent of trading volume. Reforms aimed at modernization of the secondary market have been instituted recently. The measures adopted have the aim of the provision of hedging protection, more flexible brokerage rates and the gradual introduction of continuous trading.

b. Continuous Disclosure

French corporation law provides that all shareholders are

15/ Brokers are not generally used by the average French investor, who has traditionally been wary of investment in the securities markets. The government is actively trying to encourage greater participation in the markets by small investors.

entitled to receive certain corporate information. 16/ Shareholders may read and copy at the company's registered office documents relating to a company's financial statements, inventory, names of directors and statements of the amounts paid to the ten most highly compensated employees, as well as minutes of shareholders meetings. Prospectuses are not required, however, for secondary trades.

Additionally, companies listed on an official stock exchange must publish in a legal newspaper, prior to their annual meeting of shareholders, the following documents:

- Financial statements for the most recent fiscal year, clearly stating that these are unaudited;
- List of portfolio holdings, with a breakdown by issuer of securities held and value thereof;
- Proposed allocation of profit or loss; and
- Consolidated financial statements, if available.

Within 45 days of the annual meeting, the audited consolidated financial statements must be published in final

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16/ The contents of the information to be supplied annually to shareholders used to be defined in various statutes. Recent changes in the law, however, will phase in requirements regarding disclosure of certain financial information including statements of current net assets, statements of financial position, provisional financing plan and operating statements.

form in the appropriate legal newspaper. A further statement of activity and results must be published every half-year, and trading figures must be published quarterly. Listed issuers have a general obligation to disclose information likely to affect the trading of their securities.

Somewhat different standards apply to companies not listed on an official stock exchange but which have assets of FFr 20 million (currently about $3 million) or more, a securities portfolio in excess of FFr 2 million (currently about $300,000) or 50 percent or more of the capital of which is owned by a listed corporation. These companies must publish in a legal newspaper within 45 days of their annual shareholders meeting their audited financial statements for the most recent fiscal year, the allocations of their profit or loss and their portfolio holdings.

7. Liability

The general principles of liability under tort law apply to actions for misstatements or omissions appearing in a prospectus. Such actions are much less common in France than in the United States.

Both the Penal Code and the Ordinance of 28 September 1967 (as amended by the Law of 3 January 1983) contain provisions forbidding the intentional dissemination of false information

relating to the securities of an issuer in order to influence the price of such securities.

8. Rating System, Withholding Tax, Limitations on Transferability

Bond issues in the French market are differentiated according to the quality of the issuer and divided into two categories. First category bonds are issues made by government agencies or public sector corporations regarded as having the same creditworthiness as state issuers. Second category bonds are issued by private corporations and are regarded as having a lower quality than government sector bonds. Partly as a result of the creation in early 1986 of a domestic commercial paper market, the French rating agency, Agence d'Evaluation Financiere recently was formed. 17/ In addition to commercial paper, the agency has indicated that it will rate domestic company bonds in the future.

Interest on government bonds is paid without withholding tax. Interest on other bonds, with certain exceptions, is subject to 10 percent withholding. Withholding from dividends is 15 percent. Stamp tax of 0.3 percent is payable on all

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17/ The agency is owned by insurance companies and other state and private financial institutions.

transfers of securities other than short-term bonds (defined as those having a maturity of less than 7 years).

There are no restrictions on nonresidents' trading in securities in France, although a nonresident may not own more than 20 percent of the capital of a listed French company without permission from the Finance Ministry.

9. Recent Developments

France's securities markets are presently undergoing deregulation as the recently-elected government, in which conservatives and socialists share power, denationalizes state-controlled industries and attempts to create a new base of individual shareholders in the market. One result of deregulation is the increasing regulatory role being played by the COB and the Stockbrokers' Council. As a result the government has deferred more regulatory decisions to financial experts in those organizations.

G. AUSTRALIA

1. Description of Statutory Scheme and Regulatory Authority

Australia is a federation of six states and two territories. The legislative system comprises the state and territorial legislatures together with that of the Commonwealth of Australia. The states, territories and the Commonwealth each have authority to enact securities and companies legislation. The need for uniformity in such laws led to an agreement between the states and the Commonwealth in 1978 (the "Formal Agreement") whereby the Ministerial Council for Companies and Securities (the "Ministerial Council") and the National Companies and Securities Commission ("NCSC") were established by the National Companies and Securities Commission Act 1979. Pursuant to the Formal Agreement each state or territory adopted companies and securities legislation substantively identical to that adopted by the Commonwealth. 1/

1/ The Commonwealth exerts jurisdiction in this respect only over the Australian Capital Territories. The Northern Territory is not a party to this scheme. The legislation adopted by the Commonwealth pursuant to the Formal Agreement consists principally of the following acts:

> National Companies and Securities (Commonwealth) Act 1979;
> Companies (Acquisition of Shares) Act 1980;
> Securities Industry Act 1980;
> Company and Securities (Interpretation and Miscellaneous Provisions) Act 1980;
> Companies Act 1981; and
> Several ancillary Acts, together with Regulations under each Act.

(continued . . .)

The states and the Commonwealth have agreed not to amend such legislation without the approval of the Ministerial Council. The Ministerial Council, comprising representatives from each state, is the sole body responsible for proposing companies and securities legislation. The NCSC has no rulemaking authority and is responsible to the Ministerial Council.

The eight-member NCSC, which came into operation in 1981, is the agency primarily responsible for administering all the state and Commonwealth securities legislation. Most of its powers, however, including the review of prospectus disclosure, are delegated to the Corporate Affairs Commissions ("CACs") of each state.

Securities are not "registered" prior to distribution, as in the United States, but instead a prospectus must be filed with the reviewing authority. Prospectus disclosure requirements in each jurisdiction derive from the Companies Code as well as from regulations adopted by each jurisdiction. If the securities are to be listed, the additional requirements of the Australian Association of Stock Exchanges ("AASE") must be met.

(. . . continued)
This legislation forms the basis for the state acts. The standard form in which the Companies Act 1981 is adopted by all the states is referred to herein as the "Companies Code."

The Ministerial Council approves the establishment of stock exchanges. The Formal Agreement gives the nine Australian stock exchanges substantial responsibility for the regulation of their own and their members' affairs, subject to NCSC oversight. Stock exchange rules are approved by the NCSC.

No person may deal in securities 2/ without a license issued by the NCSC under provisions of the Securities Industry Act 1980. Investment advisers are also subject to licensing. The activities of stockbrokers are self-regulated through the stock exchanges.

While all public offerings of securities are subject to government regulation, the disclosure required by the Companies Code and state regulations is not detailed. The NCSC tends not to become involved in questions of disclosure until a problem has arisen.

The regulation of stock exchanges and securities professionals is similar to the United States model, in that self-regulatory organizations (the exchanges) administer rules that are subject to regulatory agency (NCSC) approval. However, regulation is not as extensive as in the United States.

The statutory scheme covers all offerings of securities made in Australia. Only Commonwealth legislation has full

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2/ The definition of a security is broad; there are, however, several exceptions for certain types of instruments.

extra-territorial operation outside Australia (in cases of fraud, for example). It is not clear on the face of the legislation whether an offer of securities solely to persons outside Australia is required to comply with the disclosure and filing requirements outlined below. The question of jurisdiction of one state over offerings made from that state solely to persons in another state has not been addressed to any extent, principally because most listed companies are listed on all exchanges.

2. Nature of the Markets

Australia has nine stock exchanges. 3/ The Sydney and Melbourne exchanges are the largest, accounting for 95 percent of securities turnover. In terms of market capitalization, the Sydney Stock Exchange is the seventh largest in the world. It is much smaller than the leading world exchanges, however, and Australia's capital markets account for only 2 percent of world market capitalization.

The AASE regulates the operations of the six principal stock exchanges. It was formed in 1937 to adopt and maintain uniform regulations for the listing of securities on each

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3/ Sydney, Newcastle, Melbourne, Ballarat, Bendigo, Adelaide, Brisbane, Perth and Hobart.

exchange. 4/ Since 1972 the exchanges have implemented a policy of "national" listing under which all companies listed on one AASE exchange may be listed on the other five with little additional burden. Companies seeking quotation designate a "home exchange" (usually the exchange in the capital of the state where the company has its principal place of business), but may apply to be listed on more than one exchange. 5/ Technical links between exchanges, including computer quotation systems, are at an advanced stage. Screen trading and automatic settlement are planned. Listed securities may be traded off the exchanges.

Second Boards, first established by the Perth Stock Exchange in 1984, and now operating in Melbourne, Sydney, Brisbane and Adelaide, allow small firms to raise capital publicly without the expense and burden of obtaining a main

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4/ The AASE Stock Exchanges are Adelaide, Brisbane, Hobart, Melbourne, Perth and Sydney. AASE regulations require that companies seeking official listing of their securities have at least 300 shareholders (25 holders in the case of debt securities), that members of the public hold a minimum number and percentage of securities, and that the total value of the securities to be listed be A$300,000 (currently about US$194,800) for equity, A$500,000 (currently about US$324,700) for debt securities. Additional requirements apply to foreign issuers. For example, at least 200,000 shares must be held by at least 200 Australian residents.

5/ The ability to trade on all stock exchanges has prompted discussions concerning the formation of a single national stock exchange.

bearer form) are available on all exchanges. 10/ Dual class capitalization is permitted, and many variations in voting rights exist. Exchange traded options are available on a market located within the Sydney Stock Exchange.

Unit trusts are common in Australia. These are similar to mutual funds, but due largely to favorable taxation treatment, have extended beyond the type of fund that invests in other securities commonly found in other countries. Property trusts invest in real property, for example, and several trusts have been formed to conduct business operations. Interests in unit trusts and other investment vehicles (for example, bullion investments, franchising plans or afforestation schemes) are defined as "prescribed interests". Investors in prescribed interests do not have the same rights and protections afforded to shareholders (for example, voting rights and election of directors), thus fuller disclosure is mandated (*see* discussion below) and a trust deed setting out the protections afforded investors must be registered with the NCSC.

10/ Most Australian companies are fairly small, and their shares relatively illiquid compared to United States companies.

5. Primary Offerings

a. Participants in a Distribution

Stockbrokers, merchant (investment) banks, and trading banks 11/ all participate in the distribution of securities. Underwriters are usually stockbrokers or merchant banks (usually the latter in debt issues) and may accept the issue on either a best efforts or a firm commitment basis. The lead underwriter may organize a network of sub-underwriters such as merchant banks, stockbrokers and insurance companies.

Usually, when underwriting is on a firm commitment basis, the underwriter places the entire issue with investors prior to listing. Distribution in a best efforts underwriting typically takes longer. No offer or invitation to acquire the securities can be made prior to filing of the prospectus, although in practice the market acquires considerable information about the issue prior to filing. Preliminary prospectuses are not used.

Advertising of securities (particularly before filing) is restricted. Only factual information may be set out in advertisements and other restrictions apply, although relief from certain of the restrictions frequently may be obtained upon application to the NCSC. Occasionally, full prospectuses

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11/ All three of Australia's private trading banks have bought into stock brokerage firms.

are published in newspapers, but more often advertisements will invite readers to apply for a prospectus. Second Board issuers frequently use advertisements in newspapers to sell their securities directly to investors. The most common way in which securities are distributed, however, is by stockbroker placements.

Typical purchasers of securities include banks, insurance companies, stockbrokers and financial institutions. Superannuation or pension funds are thought to be the most important investors, providing a large and growing pool of investment funds. They tend to favor long-term growth securities such as public securities and long-term debt. Insurance companies generally favor more liquid investments. While about 42 percent of available equity securities are owned by individuals, such individuals make up only four percent of the population -- a much lower rate of share distribution than in other developed countries -- and tend to be retirees and wealthy speculators. Employee share ownership is being actively encouraged by the government, apparently with some initial success.

b. Disclosure and Review

A prospectus must be registered before any offer of

securities is made to the public. 12/ Exceptions from the prospectus requirement are provided for government issues; for bona fide offers or invitations to enter into an underwriting agreement; to persons in the business of buying and selling securities; to holders of prescribed interests made available pursuant to an approved deed and in relation to that interest; and to existing security holders (although the AASE requires disclosure of certain information on rights issues).

Prospectuses must include the following information:

- Financing plans, including minimum amount necessary for property to be purchased, if any, expenses and

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12/ Section 96(1), Companies Code. The Companies Code does not regulate non-public offers. There is no judicial interpretation of the meaning of "offer to the public". The Companies Code provides that offers to any "section of the public", however selected (*e.g.*, as previous clients of the distributor), are offers to the public. However, the Code does not define a "section of the public". The NCSC considers that any offer to persons who do not have a close business or personal relationship with the offeror is public. In the leading case on the meaning of public offers, the High Court held that whether an offer was public depended on the circumstances of the case. The factors to be considered are the relationship between members of the offeree group, the number of persons comprising the group, the relationship between offeror and offerees, the nature and content of the offer, the significance of any particular characteristic which identifies the members of the group and any connection between that characteristic and the offer. *CAC(SA) v. Australian Central Credit Union*, 5 A.C. 752 (1985). The High Court expressly declined to follow the United States Supreme Court's decision in *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953).

commission, money borrowed for the foregoing, working capital, and sources of other financing;

- Details of any guarantees by parent corporation;
- Statement that no securities will be issued on the basis of the prospectus later than six months after its date of issue;
- Voting and dividend or capital rights attached to securities;
- Date of any expert's reports included in whole or part;
- Details of material contracts (outside ordinary course of business or which must be described in order to prevent prospectus being misleading) entered into within last two years;
- Auditors' names and addresses;
- Details of nature and extent of interest of every director, proposed director or expert in the promotion of the company or the property proposed to be acquired (applicable only to companies within first two years of incorporation);
- For foreign companies, details of constituent documents and legislation under which incorporated, address of registered office in jurisdiction (if new to Australia), and where and when incorporated;
- States and territories in which prospectus is to be issued; and

- Whether application has been made for stock exchange listing, and upon what exchanges.

Specific textual disclosure of segment information is not required. It is not normal practice to disclose details of individual directors' remuneration. While there is no specific requirement to describe the nature of the issuer's business, in practice a prospectus will not be registered unless it adequately informs investors as to the issuer's business. The NCSC and the CACs have discretion to require issuers to include additional material in prospectuses, and frequently make use of this power.

The Companies Code and regulations thereunder require the prospectus to contain a report by a registered company auditor (a fully qualified accountant who must also meet practical experience requirements and standards of fitness and propriety) covering:

- Statement of profit and loss covering five previous years (and any part of current years for which accounts made up), unless accounts are not made up for any of these years, in which case a statement to that effect is required;
- Directors' report on material changes after date of accounts;
- Assets and liabilities as of the end of the last

fiscal year;

- Dividend history for last five years;
- Estimated payments due to and from subsidiaries;
- Amount payable on application and allotment of each share;
- Information as to previous share offerings in last two years;
- If property is to be acquired with proceeds, details of transaction and previous dealings with such property or its vendor;
- Commissions paid in last two years, and whether directors or promoters received any such commissions;
- Preliminary expenses, and by whom paid;
- Payments to promoters in last two years; and
- If debentures are to be issued, restrictions on issuer's borrowing; amount of subscriptions sought; whether charges can be made over assets that secure deposits or loans ranking in priority or pari passu with the offered securities.

Where the issuer is a member of a group, it may choose to present the group's accounts in consolidated or separate form, so long as the form used gives a true and fair view of the group's accounts. The basis of accounting adopted must be disclosed. Segment revenue and results and other items of information are required in the financial statements of all

companies with significant industry and geographical segments under the Australian Accounting Standards ("AAS"). There is no obligation to prepare accounts in accordance with AAS, but in practice the NCSC requires an explanation where AAS requirements are not met. The AAS are prepared by the two professional bodies representing accountants in Australia, using the requirements of the International Accounting Standards Committees ("IASC") as a minimum basis. AAS requirements therefore meet or exceed IASC standards. 13/

Where listing is sought, companies must also comply with AASE requirements, which complement and extend the statutory requirements (and which are fairly uniform, although individual exchanges may impose additional requirements). AASE requirements are as follows:

- Experts' reports must be included in full, must state the experts' qualifications, and may not be included if experts have interests in the property or potential property of the company in which they report;

13/ The principal differences between Australian and United States accounting practices are: (a) fixed assets are sometimes revalued, (b) properties are not depreciated, and (c) surpluses and losses on realization of fixed assets can be included both "above and below the line" under Australian practices. Additionally, United States companies usually are required to disclose a greater amount of information (e.g., pension funding).

- With respect to debt securities, the prospectus may not state on its cover that the issue is guaranteed unless an adequate description of the guarantee appears; and
- Where unsecured notes are offered, the names of all subsidiaries of the borrower that are not guarantors must be given, and reference must be made to the way in which liability limitations are calculated, the assets and liabilities of the borrower and its subsidiaries, and of the guarantor companies, showing advances to and from guarantor and non-guarantor subsidiaries, reference to the fact that in winding up a trustee can prove only against a borrower and guarantors; and main terms of covenants given by borrowing company.

Disclosure for public offers of "prescribed interests" mirrors that required for other securities. Additionally, a trust deed containing covenants regarding the management of the enterprise in which the interests are offered must be registered.

A draft prospectus is submitted to the local CAC for review together with copies of experts' consents, material contracts, consents of trustees, auditors, lawyers, bankers and stockbrokers and a statutory declaration by the solicitor engaged in preparation of the prospectus, verifying the registration copy. The CAC suggests amendments that are

incorporated into the draft in the same manner as in the United States. The process takes two to three months, sometimes longer.

Where stock exchange listing is sought, the exchange must receive the documents submitted to the CAC, and the issuer's constituent documents, within one month of announcing the closure of the offer. 14/ Appeal to the courts may be available under the Securities Industry Act of each state if the CAC refuses to register a prospectus. Review is limited to ascertaining whether the NCSC or CAC abused their powers and discretion, and the court will not address the merits of the NCSC or CAC's decision. If an exchange rejects a listing application, the courts similarly may review the matter to ensure that the stock exchange has complied with its contractual duty to give fair and honest consideration to any application, but will not address the merits of the case.

Australia does not have an integrated disclosure system. This, together with the requirement that prospectuses may not be more than six months old, means that issuers involved in repeat or continuous offerings must completely reproduce their prospectuses. In 1984, however, the NCSC approved the use of a

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14/ Off-exchange selling can take place once the prospectus is registered and issued even though listing by the exchange has not yet been granted. If listing is applied for and refused, however, all allotments and issues pursuant to the prospectus are void and money received must be returned.

summary prospectus by seasoned debenture issuers and cash management trusts. A more extensive study of the prospectus provisions is under way to determine whether to recommend an integrated disclosure and shelf registration system such as that currently in operation in the United States.

6. Secondary Market

Although the matter is not free from doubt, secondary offerings seem to be covered by the prospectus requirements to the same extent as primary offerings. Thus the practice has been to register a prospectus whenever securities are offered to the public. This is not necessary, however, for secondary trades made through the stock exchanges.

Continuing disclosure requirements are found in the Companies Code, which requires that an annual return be lodged, together with audited accounts, with the NCSC. This report is presented at the issuer's annual meeting of shareholders within 4-1/2 months of the end of the issuer's fiscal year. 15/ If a corporation has issued debentures to the public, quarterly reports and half-yearly income statements must be filed with the NCSC and the trustee for such debentures.

15/ For prescribed interests, the report must be presented within two months of the end of the financial year. No effort is made to dictate the contents of accounts relating to prescribed interests, which are prepared by the trustee.

Annual reports include, in addition to standard information about the company and its activities, the following audited accounts:

- Balance sheet;
- Profit and loss account;
- Details of consolidated profit or loss;
- Review of operations for year, results of operations;
- Events subsequent to balance date affecting results;
- Details of any securities issued;
- Dividend information on dividends received and distributed;
- Interest paid;
- Provision for bad debts and writing down of assets;
- Charges on assets and contingent liabilities;
- Unusual items in year's accounts;
- Amount of profit or loss arising from sale or revaluation of assets;
- Depreciation;
- Aggregate emoluments of directors and auditors; and
- Provision for income tax.

The AASE requires that listed issuers publish annual reports within four months of the end of the issuer's fiscal

year. The issuer's consolidated accounts must also include certain information additional to that required under the Companies Code, the most significant being the annual turnover (gross operating revenue). Non-mining companies must file preliminary annual reports with their home exchanges within three months of year-end and half-yearly reports within three months of the half-year. Mining companies submit quarterly reports with full details of their activities to their home exchanges.

7. Liability

Directors, promoters, or persons who have authorized or caused the issue of a prospectus, are liable to pay compensation to all persons who subscribe for or purchase securities in reliance on the prospectus for any loss or damage sustained by reason of any untrue statement or nondisclosure of material matters in the prospectus. A due diligence defense is available to such persons for untrue statements that were believed to be true, although strict liability apparently attaches to any nondisclosure of material matters. 16/ Common

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16/ Section 107, Companies Code. Very few lawsuits have been brought under this provision. Class actions are not available with respect to such provisions, and contingency fees are illegal. Those actions that are brought tend to be by individuals or by the regulatory authorities.

law tort liability exists but has not been applied in the prospectus context.

Persons authorizing or causing the issue of a prospectus may be guilty of a criminal offense under the Companies Code for untrue statements or nondisclosure unless they can prove immateriality or inadvertence. 17/ Liability may also attach under other legislation such as the Trade Practices Act or the Securities Industry Act. Most state criminal codes also have provisions applicable to securities matters, in particular to the making of false statements with intent to induce investment.

8. Rating System, Withholding Tax, Limitations on Transferability

Established in 1981 in Melbourne, Australian Ratings gained prominence when it correctly predicted the demise of a highly regarded Australian company. The credit agency now rates both domestic commercial paper and corporate bonds.

Withholding taxes of 30 percent are applicable to dividend payments, reduced to 15 percent for residents of countries with which tax treaties are in effect. A ten percent

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17/ Sections 108 and 563(2), Companies Code.

withholding tax is levied on interest payments, although certain exemptions are available.

Foreign funds account for about ten percent of all investment; the United States and United Kingdom are the largest investors. Such foreign investment is subject to approval by the Foreign Investment Review Board ("FIRB"), an advisory body which makes recommendations to the Commonwealth Treasurer, who is responsible for foreign investment policy. Transactions subject to review by the FIRB include acquisitions of the assets of, or substantial interests in, Australian corporations by foreign persons; proposals by foreign persons to establish finance, insurance, media, aviation or uranium businesses; proposals to invest more than A$5 million (currently about US$3.2 million); certain real estate transactions; and direct investments by foreign governments or their agencies. There are no exchange control limitations on transactions by non-residents on the stock exchanges.

H. SWITZERLAND

1. Description of Statutory Scheme and Regulatory Authority

Although federal and cantonal statutes provide some regulation of offerings of securities in Switzerland, most regulation is accomplished by the rules of self-regulatory bodies, such as the stock exchanges and the Swiss Bankers' Association. Swiss stock exchanges are members of the Association of Swiss Stock Exchanges. No federal government agency has been established to regulate the securities markets, although the Swiss National Bank, which is under supervision of the federal government, has some supervisory authority over offerings for economic reasons.

The applicable statutes, rules and agreements are as follows:

1. The Swiss Code of Obligation (the "Code") specifies limited disclosure rules for offerings by domestic issuers.
2. Cantonal laws in Basle and Zürich regulate the stock exchanges in those cantons. In Geneva, the stock exchange has adopted its own rules.
3. The Swiss Federal Law on the National Bank provides that the Federal Council may prohibit or limit

offerings for economic reasons. 1/

4. Article 8 of the Swiss Federal Banking Law provides for advance notice to the National Bank in connection with dealings in foreign securities. The National Bank may forbid or condition these offerings for economic reasons. 2/

1/ If the balanced economic development of the country is disturbed or threatened by an inflow of money from abroad, the Council may, _inter alia_:

1. limit or prohibit payments of interest abroad;
2. limit foreign exchange transactions by foreigners; and
3. limit or prohibit the acquisition of domestic securities or borrowing by foreigners.

2/ Pursuant to Article 8, banks and financial companies (defined as companies of a banking nature which do not solicit the public for deposits) which intend to conclude, or to participate in, certain transactions must inform the National Bank in advance of:

1. foreign loans, whether as an investment of the bank itself, for issue to the public or taken on commission for placement;
2. the purchase and issuance of shares of foreign companies unless the transaction is made pursuant to exercise of an option for the increase of share capital;
3. credits and investments abroad - whether made by granting a loan for more than 12 months or by purchasing foreign notes or treasury bills for 12 months or longer or for a shorter period where there is an undertaking to allow an extension for more than 12 months; and
4. participation in an initial placement of foreign bonds with a term of 12 months or more.

The National Bank is authorized to forbid or condition these transactions if the trend of exchange rates, interest rates or economic interest of the

(continued . . .)

5. The Swiss Brokerage Convention (adopted by the Association of Swiss Stock Exchanges) fixes minimum brokerage fees.
6. The Convention Governing the Admission of Foreign Securities for Trading and Listing on the Swiss Stock Exchanges adopted by the Association of Swiss Stock Exchanges refers to the Swiss Admissions Office decisions concerning listing of foreign securities on Swiss stock exchanges. Decisions of that office to refuse listing are binding, but a decision to permit listing does not obligate the exchange to list.
7. Agreement XVII of the Swiss Bankers' Association requires that the Cantonal Bank of Bern (acting as coordinating body) be notified of all public offerings by domestic issuers of debt securities in excess of a certain amount.

(. . . continued)
country warrant. The notification requirement is not applicable to transactions and participations therein where, with respect to foreign bonds, it is expected that the amount involved will not exceed SF 3 million (currently about $1.8 million) (or such other amount in excess of this amount as is fixed by the Bank) and with respect to other transactions if the amount involved will not exceed SF 10 million (currently about $6 million).

2. Nature of Securities Markets

The principal exchanges in Switzerland are Geneva, Basle and Zürich. Four other exchanges, Bern, St.-Gall, Neuchatel and Lausanne, conduct more limited trading.

Trading of securities is permitted off the exchanges both prior to and after listing. In fact, a substantial volume of securities is traded over-the-counter even though the securities are listed on the exchanges. Most trading off the exchanges is conducted by banks and financial institutions. Banks often execute trades by transferring securities among their customers' accounts to effectuate customer transactions. Recently, an active, unregulated secondary market has developed among banks and financial institutions for privately placed debt securities.

There is no officially established over-the-counter market or quotation system. The "Vorborse" is an unofficial market for trading prior to official listing on the Zürich Stock Exchange, and the "Ausserborse" is an unofficial market dominated by the Swiss Bank Corporation (one of the largest Swiss banks) and the Volksbank Willisan, Lucerne branch (a regional bank), where shares of a regional character are traded.

Unofficial trading, consisting primarily of telephone calls among banks normally commences on the "Vorborse" two days following the close of the subscription period in an initial

public offering. Official trading on the exchange takes place only after all formalities have been completed and physical certificates printed and distributed, often 2 to 3 months following the offering. The Zürich Stock Exchange has issued rules concerning trading and listing on the "Vorborse." In Geneva and Basle, there are no special rules for trading prior to listing.

3. Issuers

Most Swiss companies traded on the exchanges are large, well-known companies. Many Swiss companies remain privately held and raise capital by issuing debt in the public markets. Governmental institutions, including the Swiss Confederation, cantons, municipalities and other public institutions, offer debt securities in public markets and list these securities on the exchanges.

As of the beginning of 1986, there were 315 companies with equity shares listed on the Zürich Stock Exchange. Foreign companies accounted for 184 of this total. Of the listed companies, 19 were newly authorized in 1985 to list their equity on the Zürich Stock Exchange, with 9 of these being foreign issuers. There were new listings in 1985 of bonds and debentures totalling SF 25 billion ($10,196 million), as compared with listings of SF 21 billion ($8,769.4 million) on the Zürich Stock Exchange in 1984. The domestic private sector

accounted for SF 9 billion ($3,711.5 million) of the 1985 total, the domestic government for SF 3 billion ($1,177 million) and SF 13 billion ($5,307.5 million) were international issues. 3/

Also as of the beginning of 1986, there were 310 companies with equity shares listed on the Geneva Stock Exchange. Foreign companies accounted for 197 of this total. Of the listed companies, 18 were newly authorized in 1985 to list their equity on the Geneva Stock Exchange, with eight of these being foreign issuers. There were new listings in 1985 of bonds and debentures totalling SF 21 billion ($8,513.7 million), as compared with listings of SF 18.7 billion ($7,959 million) on the Geneva Stock Exchange in 1984. The domestic private sector accounted for SF 7 billion ($2,683.8 million) of the 1985 total, the domestic government for SF 2 billion ($852.9 million) and SF 12 billion ($4,976.9 million) were international issues.

As of the beginning of 1986, there were 291 companies with equity shares listed on the Basle Stock Exchange. Foreign companies accounted for 182 of this total. Of the listed companies, 16 were newly authorized in 1985 to list their equity on the Basle Stock Exchange, with 10 of these being foreign issuers. There were new listings in 1985 of bonds and

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3/ International bonds include Eurobonds and foreign bonds.

debentures totalling SF 23 billion ($9,168.3 million), as compared with listings of SF 17 billion ($6,903.6 million) on the Basle Stock Exchange in 1984. The domestic private sector accounted for SF 8 billion ($3,265.1 million) of the 1985 total, the domestic government for SF 3 billion ($1,177 million) and SF 12 billion ($4,726.2 million) were international issues.

4. Types of Securities Traded

A variety of financing instruments are traded in the Swiss markets. Convertible bonds, floating rate notes, subordinated debentures and warrants have gained acceptance. Bonds issued by foreign borrowers, denominated in Swiss francs, are a significant source of capital in international finance.

Foreign shares are traded on the exchange (a) as registered shares, (b) as shares registered in the name of a Swiss bank, assigned in blank by such bank, or (c) as shares registered in the name of the foreign issuer and held by one of the Swiss banks, with respect to which bearer shares are issued and traded.

Although no specific requirements regarding shares have been adopted by the various stock exchanges, as a general rule each share is required to have one vote. However, certain securities known as dividend-right certificates and participation certificates, which have some of the

characteristics of non-voting shares, may be admitted to listing.

5. Primary Offerings

Banks play a vital role in the public distribution of securities in Switzerland. Unlike their counterparts in the United States, Swiss banks actively participate in underwriting offerings, managing investment portfolios and trading in securities. Foreign investment banks and securities dealers also can participate in underwriting syndicates for domestic Swiss offerings. There is no legal requirement that a Swiss bank be among the underwriters.

Firm commitment underwritings are the most common method of distribution in Switzerland. 4/ Syndicates consisting of the largest Swiss banks account for the bulk of the volume of underwritten offerings. "Direct placements," in which the company bears the risk, recently have been utilized more frequently in private placements due to increasing competition in the international markets. However, such placements are unusual in public offerings. Subscription periods generally last five to six days following publication of a prospectus in

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4/ With respect to government bonds, in 1980 the Swiss Government introduced a tender system, with issue prices established as a function of investors' bids. Successful bidders receive the bonds at the same, uniform price.

the newspaper. The most common distribution method consists of sending short subscription forms to customers of the syndicators. The entire distribution process generally takes approximately six weeks.

Shares of a foreign company are generally introduced into the Swiss markets through portfolios of the banks' clients. Actual distribution to the public through the stock exchanges takes place when a certain amount of shares of the foreign company is held by residents in Switzerland and the company has acquired a reputation in Switzerland.

Pursuant to the Code, any offer of newly issued shares to the public must be made by means of a prospectus by which the public is invited to subscribe. 5/ The disclosure required is not extensive. 6/ It includes the latest balance sheet and profit and loss statement with an auditors' report and certain other information.

Bonds may only be submitted for public subscription or introduced on the stock exchange if a prospectus is used. 7/ Prospectus requirements for bonds are similar to those for the

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5/ Art. 650. There is no prospectus requirement under the Code when previously issued shares are offered to the public. With respect to listed companies, however, the exchanges impose such a requirement.

6/ Arts. 631, 651 Code of Obligations.

7/ Section 1156.

issue of new shares. 8/ In addition, the prospectus must contain detailed information concerning the bonds, especially the interest terms, terms of repayment, special security provided for the bonds and any representation of the bond creditors by a community of creditors. 9/

Pursuant to the stock exchange rules of each of the major exchanges, an application for listing must be filed through at least one bank or stock exchange firm which is admitted to the exchange and licensed to trade on the floor of the exchange. Following approval and application for listing, the application must be posted for at least four days on the premises of the exchange. If no objection is made by members of the Association of Swiss Stock Exchanges within this period, the securities may be listed.

Prior to listing, an introductory prospectus must appear in the daily newspaper in one of the three national languages, French, German and Italian. If the application for listing has been preceded by a public offering, the prospectus used in that offering may be used if it is no more than 6 months old. The prospectus must include the necessary information for an

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8/ Sections 1157-1186 of the Code of Obligations.

9/ The Code contains provisions vesting certain powers within a representative who may act on behalf of the creditors of bonds issued to the public by an obligor domiciled or having a business establishment in Switzerland. The provisions do not apply to governmental bonds.

assessment of the securities to be introduced. The issuer must confirm by its signature the correctness of the information contained in the prospectus and the prospectus must contain a request for listing by the sponsoring bank or stock exchange firm.

For issuances by companies that already have securities listed, the board of the stock exchange may waive the requirement of a detailed prospectus and approve admission on the basis of an abbreviated prospectus. 10/

The placement of medium- and long-term government bonds is accomplished through the use of a "tender system." The system provides for the purchase of all offered bonds at a common price which is arrived at through competitive bidding. There are no restrictions regarding who may bid for these securities.

6. Secondary Market

A large amount of secondary market trading is carried out directly among the banks and financial institutions rather than on the exchanges. The banks do not act as market-makers, but may execute transactions either in-house or with another bank

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10/ For issues by governments or municipalities, the prospectus must contain sufficient information concerning the financial status, revenues and expenditures of the public body concerned.

at the current price of the stock exchange where the security is listed.

There are no federal laws specifically restricting or prohibiting foreign persons or entities from engaging in securities transactions on a commercial basis in Switzerland. However, in Zürich and Basle, a cantonal license is required to engage in commercial transactions in securities. Such license will be provided only to an office established in the canton from which the license is requested. Representation and transmission activities of the representatives of foreign brokers located in Geneva are limited to advising and counseling local banks or non-bank financial institutions and transmitting orders given by such entities to an office abroad.

The Uniform Regulations adopted by the three main stock exchanges provide that companies whose securities are listed must publish a printed annual report to be made available to shareholders and bondholders. The bank that requests admission to listing for a company must submit the annual accounts to the appropriate stock exchange and report to the board of the exchange any change in the articles of incorporation of the issuing firm or any information received from the issuing firm which could materially affect the financial position of the company or the listing. All later publications of the company intended for shareholders (such as those relating to dividends) must appear in a daily newspaper in the city where the securities are listed.

7. Liability

Pursuant to Article 752 of the Code, individual stockholders or bondholders may bring action for statements in a prospectus regarding securities of a Swiss company that are incorrect or do not comply with legal requirements against anyone who has cooperated intentionally or negligently in the issuance. It is unclear whether these laws apply to the distribution of securities of foreign issuers. However, lower Swiss courts have imposed liability for foreign issuances where the transaction was expressly subject to Swiss law. In the absence of a specific provision in the Code, general tort liability may be imposed for securities violations.

8. Rating System, Withholding Tax, Limitation on Transferability

A withholding tax of 35 percent is imposed on dividend and interest payments. However, pursuant to a tax treaty with the United States, withholding for United States citizens on Swiss securities is reduced to 5 percent on interest and 15 percent on dividends.

The investment in a real estate company by foreigners is prohibited under a law which prohibits foreigners from purchasing Swiss real estate.

The transfer of registered shares of a Swiss issuer is sometimes restricted by the issuer to Swiss residents. 11/ No statutory provisions restrict transfer to foreigners, however.

11/ Foreign equity ownership has tended to be through bearer shares with reduced voting rights or certificates of participation with no voting rights. A bank in Zürich found a way to circumvent this practice by offering foreigners warrants for equity securities. Several other banks have followed this procedure. The underlying shares are held in blocked accounts at the banks issuing the warrants. Such warrants often trade above the issue price of the securities. They can be traded between foreigners (who thus participate indirectly in the registered share market) but exercised only by Swiss nationals.

I. NETHERLANDS

1. Description of Statutory Scheme and Regulatory Authority

The issuance and trading of securities listed on the Amsterdam Stock Exchange (the "Exchange") are subject to the regulations of the Exchange. The implementation of these regulations is largely carried out by the Amsterdam Stock Exchange Association, a self-regulatory organization.

In addition, the Netherlands recently enacted the "Securities Trading Act" (the "Act"), 1/ to regulate trading in unlisted securities, and the Securities Trading Decree (the "Decree") to implement parts of the Act. The Act, which does not apply to securities listed on the Exchange, prohibits the following activities (except under limited circumstances) in or from the Netherlands:

(1) making a primary offering of securities to individuals not engaged in the business of dealing or investing in securities without making available a prospectus that meets the requirements of the Decree;

(2) acting without a license as an intermediary in securities transactions for individuals or

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1/ October 30, 1985. The Act took effect on May 1, 1986, although its main prohibitions apply as of July 1, 1986.

companies which do not regularly issue securities or engage in the business of investing or trading in securities; and

(3) offering without a license units of participation in a mutual fund to individuals or companies not engaged in the business of dealing or investing in securities.

The Act on the Supervision of the Credit System may apply concurrently with the Act with respect to the public issue of debentures with a denomination of less than DG 100,000 (currently about $44,000) unless (1) the instruments are or will be listed on an exchange (excluding the Parallel Market discussed below) in the European Communities, or (2) the company issuing or dealing in the instruments is registered and subject to supervision by De Nederlandsche Bank NV as a "credit institution."

The Minister of Finance (the "MOF") is charged with granting licenses and exemptions under the Act, and, pursuant to the Stock Exchange Law of 1914, supervises the Exchange. The Stock Exchange Listing Decree of 1983 (the "1983 Decree") implements certain of the EEC directives and distributes the powers of the competent authority, within the meaning of the

directives, between the MOF and the Exchange. 2/ The 1983 Decree provides that any amendment to the Exchange Listing Manual must be presented to the MOF for prior approval.

2. Nature of Securities Markets

The Exchange is the only securities exchange in the Netherlands, although the Amsterdam Parallel Market (the "Parallel Market") exists as part of the Exchange, with less stringent listing requirements. The European Options Exchange and a gold futures market are also located in Amsterdam. Both domestic and foreign companies may be listed on the Exchange and on the Parallel Market.

3. Issuers

As of the beginning of 1986, there were 474 companies with equity shares listed on the Exchange. Foreign companies accounted for 242 of this total. There were new listings in 1985 of bonds and debentures totalling DG 42 billion ($12,694.4 million), as compared with listings of DG 31 billion ($9,743.9 million) on the Exchange in 1984. The domestic private sector accounted for DG 11 billion ($3,276.3 million) of the 1985 total, the domestic government for DG 27 billion ($8,026.8

2/ *See* discussion in part IV.A., *supra.*

million), and DG 4 billion ($1,355.3 million) were international issues. 3/

4. Types of Securities Traded

Securities traded on the Exchange are usually in bearer form. If the securities are in registered form they are often deposited with a depositary and the depositary receipts are traded in bearer form. Both corporate and government bonds are exchange listed, as are shares of investment companies and funds. Eurobonds are traded but not officially quoted.

5. Primary Offerings

a. Participants in a Distribution

The major banks play a primary role in the distribution process, acting both as investment banks and securities brokers. There are also companies other than banks that specialize in the securities industry. For an offering solely in the Netherlands, a major bank is generally selected for placement of the issue. The bank may syndicate the issue with other banks or securities firms. Although no law prohibits

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3/ International bonds include Eurobonds and foreign bonds.

foreign participation in underwritings, as a matter of practice, foreign firms do not act as lead managers of guilder-denominated bond issues in the Netherlands unless Dutch banks are afforded comparable treatment in the parent country of the foreign firm.

Offerings may be made on a firm commitment or a best efforts basis. The listing manual of the Exchange provides that, in the case of an underwritten issue of debentures for a principal amount of DG 150 million (currently about $66 million) or more, all banks and securities brokers who are members of the Exchange and who qualify must be invited to act as major underwriters or minor underwriters. This group must be allowed as a whole to participate in up to 25 percent of the issue. In the case of a multinational offering, this requirement might not be imposed, provided allotments are made among members of the Exchange on a systematic basis.

Securities issued by the government of the Netherlands are marketed by the MOF, which offers the securities for auction to members of the Exchange. No other public authorities or institutions in the Netherlands issue securities but rather finance capital improvements through private placements or issues floated by the Bank Voor Nederlandsche Geemeenten (Bank for Dutch Municipalities) or the Nederlandse Water Schap Bank (Bank for Dutch Waterboards) on the Exchange. The offerings of the Bank for Dutch Municipalities are marketed by a group of

Exchange members, while the offerings of the Bank for Dutch Waterboards are underwritten by a syndicate of Dutch banks.

b. Disclosure Requirements

The Act permits the sale (other than within a limited group) in or from the Netherlands only of securities that are or will be officially listed on an exchange (as defined in the Act), of unlisted securities offered with a generally available prospectus that meets the requirements of the Decree and to which every written announcement of the offer refers, and securities for which an exemption applies or a dispensation from the MOF has been granted. The prospectus requirements are based on the regulations of the Exchange and closely resemble the listing directives of the EEC.

An "exchange" is deemed to include any securities exchange in the Netherlands or in one of the of the Member States of the European Communities or an exchange designated as such by the MOF. The Swiss exchanges of Basle, Bern, Geneva, Lausanne and Zürich and the United States stock and futures exchanges subject to the supervision of the Securities and Exchange Commission (including NASDAQ) or of the Commodities Futures Trading Commission have been so designated by Ministerial Decree. The Parallel Market is also considered an exchange.

The requirement for a prospectus with respect to securities that are not listed or for which an exemption or

dispensation is unavailable also applies to secondary offerings of securities, defined as including those that have only been available to a limited group since issuance. A limited group has been interpreted as a group that is of limited size and clearly defined, where there is more than just a financial relationship between the group and the party offering the securities and the offer is open for acceptance only by the members of the group.

The Decree sets forth the prospectus requirements for unlisted securities. The requirements depend on the type of securities being offered. Every prospectus for unlisted securities must contain a statement from an "expert" 4/ that the prospectus contains the information required pursuant to the provisions of the Decree.

The prospectus contains information regarding the securities, the persons responsible for the content of the prospectus, including the experts, and the issuing institution. The prospectus also describes the issuer's capital, activities, management and prospects, and includes balance sheets and profit and loss accounts and statements of source and

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4/ An "expert" is a registered accountant or a person to whom a license has been granted by the Minister of Economic Affairs as a certified accountant (an administrative consultant registered pursuant to the Certified Accountants - Administrative Consultants Act) and includes persons admitted as accountants by a revocable license from the Minister of Economic Affairs on the basis of a certificate of professional proficiency obtained abroad.

application of funds for the last three financial years, which must be audited. The latest financials must be no more than 18 months old at the time the prospectus is made available. If more than nine months have expired since the end of the last financial year, unaudited interim figures for the first six months must be included with the prospectus.

A prospectus is also provided with respect to government securities, but it generally contains more limited information than that required by private issuers.

c. Listing Procedures

The Exchange imposes requirements as to the minimum volume of a placement and, in the case of listed securities, the minimum portion thereof to be available for subscription by the public. The Exchange also requires that a prospectus be available as a precondition to listing; however, an exception may be granted in the case of an offering of an additional portion of the securities of a listed company not exceeding 10 percent of the number or corresponding value of securities of the same category that have already been admitted to listing. Such an exception will only be granted if sufficient particulars have been announced regarding the number and kind of securities to be admitted and the terms and conditions of the issue.

The Exchange reviews the prospectus or information submitted pursuant to an exception from the prospectus requirement, and must give its approval prior to publication.

In the case of an underwritten offering, the sponsoring bank advertises in the "Bulletin" of the Exchange that on the next business day copies of the prospectus will be available at the offices of the Exchange and of the sponsoring bank. On the day on which the prospectus first becomes available, an application for admission to official listing must be filed with the Exchange. The application must be signed by the issuer and the sponsoring bank.

The MOF admits securities to official listing, but has delegated to the Exchange the power to admit securities provisionally subject to admission by the Minister. The Exchange has the power to suspend a listing and to delist securities.

A prospectus is required for subsequent offerings by listed companies, but may be waived by the Exchange.

6. Secondary Market

The Exchange requires companies listed either on the Exchange or Parallel Market as a part of their continuing disclosure obligations to, inter alia, make available to the public, as soon as possible and within a period established by the listing agreement, annual accounts, an annual report and a

half yearly report, and to inform the public of any changes in information stated that may affect shareholder rights or facts or occurrences that may have a substantial influence on the price of the securities.

In the case of a non-Netherlands issuer, the information may be in English. The information must be made available either by advertisement or in some printed form available in a manner indicated by advertisement. In addition, the issuer must publish information on dividends.

7. Liability

Breach of provisions of the Act constitutes a criminal offense under the Economic Offences Act and may result in a penalty of six months imprisonment and/or a fine of DG 10,000 (currently about $4,500) or DG 25,000 (currently about $11,000) in case of aggravating circumstances. The Penal Code also contains provisions which may apply in the case of fraudulent conduct in connection with securities transactions.

8. Rating System, Withholding Tax, Limitation on Transferability

There are no Dutch rating agencies.

Dividends must be payable in Amsterdam and an issuer of listed securities must appoint a paying agent in Amsterdam.

Dividends are subject to a 15 percent withholding tax. Interest on bonds is paid without withholding tax.

There are no restrictions on the purchase or sale of securities on the Exchange. Profits and revenues may be repatriated at will.

V. TENDER OFFERS

A. INTRODUCTION

The tender offer, which has been an important technique for acquisition of publicly-held corporations in the United States for a number of years, is becoming an increasingly important technique in the foreign and international markets as well. The principal advantage of the tender offer is that, unlike other forms of acquisition, approval by the board of directors of the subject company is not required. In the last decade, an increasing number of foreign bidders have utilized tender offers to acquire United States corporations, often on a hostile basis. For example, in fiscal 1986, 21 tender offers subject to the Commission's rules were filed by foreign bidders for the securities of domestic corporations. Seven of those offers were not approved by the target's board of directors.

By commencing a bid for a domestic corporation, foreign companies subject themselves to the same federal and state regulatory requirements that apply uniformly to foreign and domestic bidders. Even where the foreign bidder is seeking control of another foreign corporation, United States law governing tender offers may apply if the offer is made to shareholders residing in the United States. Compliance with United States tender offer regulation, however, may pose compliance issues for foreign bidders. In addition, foreign bidders may face regulatory requirements that restrict the

ability of foreign investors to participate in certain industries.

With the internationalization of the securities markets, tender offer bids to acquire control of corporations with shareholders residing worldwide must comply with the regulatory requirements of a number of countries and political subdivisions. This is a particularly significant concern with respect to exchange offers, where the securities offered by the bidder in exchange for the target's securities must comply with the registration and distribution requirements in each country where the securities are offered.

The following sections provide a summary of the basic regulatory requirements with respect to tender offers of the United States and eight other countries. The special regulatory requirements and problems facing foreign bidders when making a tender offer in the United States are also examined.

B. COMPARATIVE STUDY OF TENDER OFFER REGULATION

UNITED STATES

1. Regulation

Tender offers for the securities of companies reporting under the Securities Exchange Act of 1934 are regulated by the

Securities and Exchange Commission ("Commission") under the Williams Act provisions of the Act. Additionally, exchange offers are subject to registration under the Securities Act of 1933. The majority of states have also passed takeover statutes. The New York Stock Exchange also has rules relating to takeovers, but for the most part these rules are less stringent than the Commission rules. Section 13(d) of the 1934 Act imposes reporting requirements for substantial acquisitions of equity securities. Section 13(e) relates to tender offers by an issuer for its own securities. Section 14(d) requires any person making a tender offer for another company's securities to file information with the Commission and disseminate it to shareholders, as well as comply with certain procedural safeguards. Section 14(e) is an antifraud provision relating to tender offers.

The term "tender offer" is not defined, necessitating interpretation on a case-by-case basis by the courts. The dividing line between pre-offer acquisitions subject to Section 13(d) and tender offers subject to Section 14(d) is unclear.

2. Procedures

The federal securities laws do not require that persons acquiring over a certain percentage of another company's securities commence a tender offer. The 1934 Act requires only that any person acquiring the beneficial ownership of more than

five percent of a class of equity security registered under the 1934 Act must disclose such holdings, and all material changes therein, on a Schedule 13D or 13G filed with the Commission within 10 days of the acquisition. Information concerning the person acquiring the securities, including his citizenship, as well as the person's plans and proposals with respect to the subject company must be disclosed.

Concurrently with making a tender offer that would result in ownership of more than five percent of a class of registered equity security, the person or group making the offer must file a Schedule 14D-1 with the Commission. The Schedule 14D-1 must also be delivered to the target company, any other bidder having filed a Schedule 14D-1 relating to the same class of securities, and each national securities exchange upon which the target class of securities are listed. The staff of the Commission will normally review and comment on the disclosures shortly after the filing of the Schedule 14D-1.

Substantially all the information required by Schedule 14D-1 must also be disseminated to the target shareholders. This may be done by long form publication (i.e., publishing all information in a newspaper advertisement); by summary advertisement with full tender offer material being furnished to shareholders requesting such material; or by mailing the materials to the subject company's shareholders. The subject company must on request either provide the offeror with its shareholder list or distribute the materials itself.

Within 10 days of dissemination of the offer, the subject company must disseminate to its shareholders a statement disclosing whether it recommends acceptance, recommends rejection, is taking a neutral position or is unable to take a position. The reasons for the target's stance, including its inability to take a position, must be stated. Other information as set forth on Schedule 14D-9 (see below) must be disseminated to the shareholders. The Schedule 14D-9 is also reviewed and commented upon by the Commission's staff. Simultaneous with distribution to shareholders, the subject company must file the Schedule 14D-9 with the Commission, and deliver copies to the offeror and each exchange upon which the target securities are listed. Third parties making solicitations or recommendations must also deliver copies of Schedule 14D-9 to the SEC, exchanges, the offeror and the subject company.

Issuers making a tender offer for their own securities must file a Schedule 13E-4 with the Commission. Purchases by a target during a third party tender offer are also subject to disclosure requirements under Rule 13e-1. If the purchases by an issuer or an affiliate of the issuer result in the securities no longer being publicly traded, compliance with the disclosure requirements of the Commission's "going-private" rule, Rule 13e-3, which is designed to elicit disclosure relating to the fairness of the transaction, will be required.

3. Disclosure

Disclosure under Schedule 14D-1 covers the following matters:

- Information about the offer, including expiration date, offering price, withdrawal rights, proration;
- Trading history of the subject security;
- Information about the offeror and its officers, directors, partners, and controlling persons, including employment histories and involvement in violations of securities laws;
- Past contracts, transactions, or negotiations with target;
- Source and amount of funds or other consideration used in offer;
- Purpose of offer and plans of offeror after acquiring securities to effect extraordinary corporate transactions;
- Holdings of offeror and its principals in subject company; transactions in subject company's securities in the last 60 days;
- Terms of any contracts, understandings, or relationships with respect to target's securities;
- Persons offeror has retained to assist in offer; and

- In the case of an exchange offer, financial information about the offeror.

The information to be disclosed on Schedule 14D-9 covers the following matters:

- Any conflicts of interest between filing person or affiliates and (a) the subject company, its affiliates, officers and directors, or (b) the offeror, its affiliates, officers and directors;
- Nature of and reasons for solicitation or recommendation;
- Identity of any person retained in connection with the solicitation or recommendation;
- Transactions in subject class of security effected by filing persons, officers, affiliates or subsidiaries in last 60 days or intentions of such persons to sell or hold such securities; and
- Any negotiations or transactions being conducted in response to the tender offer that would result in (a) extraordinary corporate transactions such as merger or reorganization involving the subject company or any subsidiaries, (b) purchase, sale or transfer by the target of material assets by the target or subsidiaries, (c) tender offer for, or acquisition of, target's own or another's

securities, or (d) any material change in target's capitalization or dividend policy.

4. Substantive Protections

Offering Period: Commission rules require that a tender offer be open for a minimum of 20 business days from the time it commences. There is no specified time by which it must be completed. The offer must extend at least 10 days beyond any announcement of a change in tender price or change in the number of securities to be acquired. Any other material change in the terms or conditions of the offer will likewise require the bidder to extend the offer.

All-holders: Tender offers must be made to all holders of the class of securities subject to the offer, unless prohibited by a state statute from making offers in that state.

Best Price: The consideration paid to any shareholder pursuant to an offer must be the highest consideration paid to any other shareholder during that offer.

Withdrawal Rights: Commission rules provide that any person who has deposited securities pursuant to a tender offer has the right to withdraw any such securities during the period such offer remains open. Tendered securities that have not been accepted for payment may be withdrawn after 60 days following commencement of the offer.

Proration: Partial offers are permitted, and proration is required.

Antifraud Provisions: In addition to the general antifraud provisions of Rule 10b-5, Rule 10b-13 prohibits purchases of subject company securities by the bidder otherwise than pursuant to the tender offer; Rule 10b-6 regulates purchases by the bidder of the securities it offers in an exchange offer; and Rule 10b-4 prohibits short tendering in connection with any tender offer.

Section 14(e) prohibits fraudulent, deceptive or manipulative acts in connection with a tender offer and gives the Commission authority to define and prescribe means to prevent such fraudulent practices. Pursuant to this authority, the Commission established a "disclose or abstain from trading" rule. Rule 14e-3 prohibits communicating or trading while in possession of certain material nonpublic information, if any person has taken substantial steps toward commencing a tender offer.

UNITED KINGDOM

1. Regulation

In practice, the control of tender offers is exercised by the Panel on Takeovers and Mergers, a self-regulatory body sponsored by the Bank of England and the institutions using the London securities market (the "Panel"). 1/ The Panel works closely with the Stock Exchange, and both the Stock Exchange and the Panel require disclosures to be made in takeovers. The Panel's requirements are set out in the City Code on Takeovers and Mergers (the "City Code"), which sets out general principles for the regulation of tender offers. The City Code applies to public and certain private companies, while Stock Exchange disclosure requirements apply only to listed companies.

1/ The Department of Trade and Industry ("DTI") exercises authority over fraudulent or misleading statements made in circulars relating to takeovers and may regulate the contents of such documents issued by parties licensed by the DTI. The DTI and other government bodies also have the power (never yet used) to prohibit foreign acquisitions in strategic industries. Additionally, the Financial Services Act 1986 sets out the circumstances in which persons holding 10% or less of the shares of a company may require or be required to have their shares compulsorily purchased. Other than these provisions, takeover activity is basically self-regulated.

Additional requirements relating to the acquisition of shares are imposed by the Rules on the Substantial Acquisition of Shares ("SAR"), which are promulgated by the Council for the Securities Industry, a self-regulating organization. The SAR is not concerned only with takeovers. The SAR regulates the purchase of shares representing five percent or more of the voting rights of a company where such an acquisition, when added to the acquiror's existing holding, would represent more than 15 percent of the target's voting rights.

Neither the Code nor the SAR have legal force, but in practice they are the universally recognized market controls in this area. The Code has been referred to in court proceedings, where it has been used as a guide to good commercial practice. Non-compliance with the Code's provisions will likely lead to consequences such as loss of licenses to trade on the Stock Exchange.

In addition to setting standards for disclosure and procedure in takeover situations, the Code provides that where any single acquiror acquires more than 29.9 percent of the issued voting capital of a company, it must make an offer for the remaining shares.

2. Procedure and Filing

When a company is notified of a person's serious intention to make an offer, that target company must issue a press notice

immediately, followed by a circular to its shareholders and to the Panel. Within one month the offeror must distribute an offer document to target shareholders. This document is subject to the general principle articulated in the Code that such documents must be prepared with the same care as if they were prospectuses. In the case of a listed target company, the offer document is reviewed by the Stock Exchange prior to dissemination. If the target shares are not listed, the offer document need not be reviewed provided that it is being sent to shareholders by a licensed or exempted dealer. Where this is not the case, DTI review and approval must be obtained. Copies must be delivered to the City Panel upon dissemination to shareholders. The Panel, which may be consulted prior to distribution of the offer document on points of difficulty, sometimes requires additional disclosure to be made by supplementary circulars.

In the case of an exchange offer, where the securities offered are to be listed, "Listing Particulars" complying with the disclosure requirements of the Stock Exchange must be distributed together with the offering circular. These give full details of the securities offered as consideration.

The Code provides that the target company's board of directors should advise shareholders of its views on the offer as soon as practicable within publication of the offer document and normally within 14 days.

Offers may be made subject to certain conditions. Offers are usually conditional upon acceptances being received for at least 90 percent of the voting capital and the Code provides that offers must normally be conditional upon acquisition of at least 50 percent. Specific and objective conditions outside the offeror's control may also be attached.

During the course of a tender offer, under a recently amended rule, all beneficial holders of one percent of the target's and offeror's shares must report changes in their holdings on a daily basis.

3. Disclosure

The Code requires that an offeror give details of the following (some of which requirements are incorporated by reference from the Stock Exchange's rules) in its offer document:

- Date of offer, precise terms, how to tender securities;
- Names of offeror and offeror's directors;
- Offeror's intentions regarding the continuation of target's business;
- Intentions regarding any major changes to be introduced in target's business; any redeployment of target's fixed assets;

- Long term commercial justification for proposed offer;
- Intentions as to employment and pension rights of target's employees;
- Holdings of shares in target by offeror and its associates; recent price history of target securities;
- Dealings with target by offeror and its associates;
- Details of agreements with target directors; proposed compensation for loss of office;
- Target shareholders' rights;
- Where the offer is for cash, a confirmation by a third party that sufficient funds are available;
- Where the offer could result in a holding by the offeror of at least 50 percent but less than 100 percent of the target, a statement must be included to the effect that a successful bid may involve transfer of control of the company without the offeror being required to make an offer for the minority shareholding;
- In exchange offers, holdings of offeror's directors in offeror's securities; how directors will be affected by transaction;
- Financial information about offeror:
    - (a) five years' financial statements;
    - (b) latest published audited balance sheet;

(c) material changes in offeror's position since last audited report;

(d) any preliminary or interim financial information released; and

(e) significant accounting policies, important points from notes;

- For listed companies only: Details of both offeror and target's turnover, net profit before tax and rate of dividends for last five years;
- Offeror's business, financial and trading prospects;
- Disclosure of ultimate owner of shares;
- Wording advising shareholders to seek professional advice on the offer; and
- In exchange offer, next dividend or interest payment in which new securities will participate, effect of acceptance of offer on offeror's assets, rights of such securities.

The target company's board of directors' circular must cover the following matters:

- Board's view on offeror's plans for company and employees;
- Target's holdings in offeror, directors' holdings in offeror, independent adviser's holdings in

offeror, directors' intentions as to acceptance of the offer regarding their own shares;

- Directors' service contracts, recent changes therein; and
- Arrangements with regard to dealings in target securities.

The Code also requires that the target board obtain competent independent advice on the offer and make the substance of such advice available to the shareholders.

4. Substantive Protection

Minimum Offering Period: Any offer to the public must remain open for at least 21 days and if it has become unconditional, it must remain open for a further 14 days unless the offeror has stated that no extension beyond the closing day will be made.

All-holders: Equal treatment of all shareholders of the same class is required under the Code.

Best Price: If, while the offer is open, the offeror or any person acting in concert with it purchases shares at a price above the offer price, it must increase its offer price to such higher price, and make an immediate announcement to that effect.

Withdrawal Rights: During the first 42 days after the dissemination of an offer document, no accepting shareholder may withdraw unless the offer has lapsed, or the offeror has failed to comply with certain obligations under the Code. If the offer has not become unconditional as to acceptances after 42 days, then shareholders may withdraw for any reason.

Proration: The City Panel's consent is required for partial offers, which are infrequently made. The Panel may require that partial bids seek statutory control (over 50 percent). Proration is required in the case of partial offers.

Regulation of Purchases Outside the Offer: Unrestricted purchases on the exchange may be made until the 30 percent threshold is met. During an offer for all shares, purchases may be made on the Stock Exchange, although the price paid may affect the offer price. No such purchases are permitted during a partial offer.

Shareholder Approval: Offers that would result in acquisition of over 30 percent of the voting rights, must be approved by a majority of the shareholders; approval is manifested by checking a box on the acceptance form.

JAPAN

1. Regulation

Takeover activity in Japan is regulated by the Securities Bureau of the Finance Ministry ("MOF"). Regulation of tender offers did not exist at all until 1971, when the Securities and Exchange Law of 1948 was amended by the MOF Registration Ordinance Concerning Takeovers, No. 38 of June 9, 1971. Conditions and methods of buying are prescribed by MOF Cabinet Order No. 321 of September 30, 1965 (Amended 1971). Takeovers are rare in Japan, and the introduction of this law represented an attempt to create a structure to deal with anticipated developments in the securities market.

As in the United States, tender offers are not the only means of acquiring large interests in companies. Open market purchases and negotiated transactions may occur without triggering a requirement that a buyer make a tender offer. A tender offer is defined as a public offer to buy, outside the securities markets, shares and other equity-related securities issued by public companies. Tender offers resulting in less than ten percent of the target company's shares being owned by the offeror are not subject to regulation.

2. Procedure and Filings

A tender offer statement containing specified disclosures and other documents relating to the offeror and the terms of the offer is required to be filed in preliminary form with the Finance Minister ten days before it becomes effective. The MOF reviews the documents for adequacy of disclosure. Foreign offerors must use a securities company or bank as their agent in such filings. The offeror must also file a certificate as to the existence of the necessary funds. Prior to the effective date, the offeror sends a copy of the tender offer statement to the target company. After the effective date, a copy must be sent to the stock exchange where the target securities are listed, and a notice of the tender offer must be published in two or more newspapers. The MOF regulates the contents of the public notice.

The offeror must make the offer through a securities corporation. No purchases may be made until the shareholders receive explanatory materials containing the same information as the tender offer statement filed with the MOF and generally similar to the prospectus that would be used in a public offering.

The target company is not required to provide a recommendation to shareholders, but if one is issued, it must be filed in advance with the MOF.

Only two conditions may be imposed on the offer. The offeror may require that a minimum of 45 percent of the target's shares be tendered. Additionally, the offeror may qualify its offer with a provision for possible withdrawal in the event of a change in the target's business circumstances that would seriously undermine the offeror's reasons for making the offer.

Unregulated tender offers (i.e., those for less than ten percent of the target's shares) are subject to prior approval by the securities exchange if the target securities are listed, or the Securities Dealers Association if unlisted.

Japan imposes restrictions on acquisitions of more than ten percent of certain shares of Japanese issuers by foreigners. A report must be made regarding the proposed acquisition, through the Bank of Japan, to the MOF and the minister in charge of the target's industry. A waiting period is prescribed before consummation of the deal.

3. Disclosure

The tender offer registration statement is prepared following the format of Form 1 and covers the following matters:

- Purpose of the offer;
- Duration of offer;

- Number of shares to be purchased, existence of any withdrawal rights;
- Price;
- Source and amount of funds;
- Description of offeror and its affiliates; and
- Offeror's and affiliates' holdings in target company's shares.

If the target company makes a recommendation with respect to a tender offer, its communication must include the following information:

- Grounds for its recommendation;
- Details of discussions at board meeting regarding any recommendation;
- Number of shares in target held by management; and
- Any benefits promised to target management by offeror.

4. Substantive Protection

Minimum Offering Period: A buying period of 20 to 30 days from the date of public offer is mandated.

All-Holders: All shareholders must be treated equally.

Best Price: The offer price may not be decreased, and if increased must be received by all tendering shareholders.

<u>Withdrawal Rights</u>: Shareholders may withdraw freely from agreements to sell target shares during the first ten days following the initial public notice of the offer or the announcement of an alteration to the offer.

<u>Proration</u>: Partial offers are permitted and proration required.

<u>Regulation of Purchases Outside the Offer</u>: In general, purchases in the market are prohibited during a tender offer.

CANADA

1. Regulation

As with other aspects of securities regulation in Canada, the conduct of tender offers is regulated at both the federal and the provincial levels. Where the target is a corporation incorporated under the Canada Business Corporations Act ("CBCA"), the provisions of CBCA apply to takeover bids for such corporation's securities. The CBCA is administered by a government-appointed director (the "Director"). Other federal statutes may also apply. At the provincial level, the provisions of the companies legislation under which a target is incorporated may relate to takeovers, and the Securities Commissions of Alberta, British Columbia, Manitoba, Ontario, Quebec and Saskatchewan all regulate takeovers where holders of target securities reside in those states. The other provincial jurisdictions do not regulate takeovers. A tender offer may thus have to comply with several sets of regulations.

Among the provinces, Ontario has traditionally taken the lead in securities regulation, and its takeover legislation, as embodied in the Ontario Securities Act, has been accepted as a model by the other provinces that regulate takeovers.

The CBCA provides that a takeover takes place once a 10 percent threshold has been met with reference to the securities of a corporation incorporated under its provisions. The

Ontario Securities Act provides that a takeover bid is in progress when a 20 percent acquisition threshold is met. Most other provinces also use the 20 percent threshold figure. In each case when a person purchases or offers to purchase a number of securities that, when added to such person's other holdings, equals the threshold percentage of similar voting securities, that person must comply with the code of conduct set forth in the applicable statutes.

Most applicable Canadian statutes exempt certain acquisitions from the statutory code of conduct. These may include takeover bids made through the facilities of and in accordance with the rules of a stock exchange, takeovers by private agreement with a limited number of security holders, "creeping acquisitions" and transfer of control blocks. The stock exchanges themselves prescribe the manner in which the first category of exempt acquisitions may be made.

It should be noted that Ontario provides that "follow-up" offers must be made where securities are acquired at a premium in transactions exempt from the statutory code of conduct. In such cases the offeror must make an offer of at least the premium price to all holders of the same class of the securities that were acquired in the exempt transaction.

2. Procedure

As in the United States, several Canadian provinces (including Ontario) impose reporting requirements upon persons acquiring significant holdings in companies' voting securities. Acquisitions made prior to the triggering of a tender offer are thus reportable.

Once the threshold requirement has been met, Ontario requires that each target shareholder be provided with a copy of takeover bid circular comprising certain prescribed disclosure (see below). This is not subject to any review. Within 10 days of the date of the offer, the target board of directors must send a directors' circular to each target shareholder. This is also subject to no review.

A similar procedure is in effect in Quebec, but there the documents produced by both the offeror and the target board must be filed with the Quebec Securities Commission ("QSC") upon the day of distribution. The QSC may require further disclosure.

Some provincial jurisdictions only require the use of a directors' circular where the directors of the target company are making a recommendation as to acceptance or rejections.

The CBCA also requires the distribution of a takeover bid circular in prescribed form. This circular must be sent concurrently to each target shareholder resident in Canada, each target director and filed with the Director. The target

directors must also distribute a circular. They need not distribute it until at least seven days before the bid terminates or before the sixtieth day of the offering period, whichever is earlier. If it is not distributed within ten days of the offeror's circular, the directors must notify target shareholders that a directors' circular will be forthcoming and may recommend that they do not tender their shares until they receive the directors' circular. The directors' circular must be sent to the target directors themselves, to each target shareholder resident in Canada, to the offeror and to its directors. A directors' circular must be sent whether or not the directors make any recommendation as to the offer.

The only conditions upon which an offer may be made under Ontario law are that a minimum number of shares must be tendered, that undisclosed actions prior to the date of the offer shall not result in material change to the affairs of the company, and that any necessary regulatory approvals be obtained.

3. Disclosure

Disclosure required by Ontario in takeover bid circulars is set out in Form 31 under the Ontario Securities Act. The contents of Quebec's Schedule XI are almost identical and the CBCA disclosure requirements are substantially similar. Form 31 requires disclosure of:

- Holdings and recent trading in target's securities by offeror, associates, directors, and principal shareholders;
- Terms and conditions of bid, method and time of payment;
- Statement that right to withdraw deposited securities exists for 10 days from date of offer;
- Recent volume of trading in target securities;
- Holdings of directors, officers, etc. in offeror;
- Details of any arrangements or agreements between offeror and target officers and directors, including compensation for loss of office;
- Interests of target officers and directors in material contracts of the offeror;
- Details of trading in target's shares by target officers and directors, target itself. The CBCA requires details of all recent trading in target securities;
- Material changes in target's business since last published financials. The CBCA requires distribution of latest published financials in the directors' circular; and
- If approval or rejection of offer is being considered by board, such may be stated and a recommendation made that shareholders' decisions

be deferred until the board reaches a decision.

The CBCA requires details of directors' and officers' service contracts and recent changes therein, and also that the reasons for any recommendation or failure to make a recommendation be given.

In certain circumstances circulars relating to individual directors or officers may be distributed.

4. Substantive Protection

Minimum Offering Period: Ontario requires an offering period of at least 21 days. In the case of partial offers, the offering period may not exceed 45 days. The CBCA provides for similar time periods.

All-Holders Rule: Ontario requires tender offers to be made to all holders of the class of securities sought and all holders of any securities convertible into the securities sought, at the same consideration.

Best Price: Under Ontario law, if during the course of the offer the offeror pays a higher price than the offered consideration for any securities covered by the offer, the offer price is deemed increased. The CBCA contains similar provisions relating to securities tendered pursuant to the offer or purchased outside the offer.

Withdrawal Rights: The Ontario Securities Act permits shareholders to withdraw securities deposited for a period of ten days from the date the offer is made. The CBCA permits target shareholders to withdraw their shares within ten days after the bid is made in all cases, and, in the case of bids for all target securities, at any time after 60 days after the date of the bid, if not taken up by the offeror.

Proration: Both Ontario law and the CBCA permit partial offers and require proration.

Regulation of Purchases Outside Offer: Ontario permits purchases to be made on securities exchanges outside the offer. The CBCA also permits such purchases, but the offeror's intent to make them must be stated in the takeover bid circular.

FEDERAL REPUBLIC OF GERMANY

No formal procedural rules regulating takeover bids exist. Takeovers may, however, be subject to regulation under antimonopoly legislation and the government may restrict the acquisition of shares in companies in certain sensitive industries.

In 1979, the Stock Exchange Committee of Experts, affiliated with the Ministry of Finance, promulgated a set of guidelines relating to takeover bids, entitled "Guidelines for Public, Voluntary Purchase and Conversion Offers and/or Indications to Make Such Offers for Officially Quoted or Semi-Officially Quoted Shares or Transfer Rights" (the "Guidelines"). The Guidelines are not binding and do not give rise to any sanction if breached.

The Guidelines' objectives are equal treatment of all shareholders and adequate disclosure, and they apply to both the offeror and the target.

The Guidelines require that the target of a takeover bid and the stock exchange on which its shares are listed be notified of the bid, and the target's statement be requested.

Immediately thereafter the offeror should publish the offer. The Guidelines state that the offer should contain the following information:

- Name of offeror;

- Class (and maximum number) of shares covered by offer, price offered, how price reached;
- Objectives of offer;
- Offeror's holdings of target's securities, and target's in offeror's securities;
- Statement of target company, if available;
- How offer can be accepted;
- Term of offer;
- Circumstances in which offeror can withdraw;
- Indication that shareholder has right to withdraw;
- Date of payment, tax information; and
- Undertaking by offeror to pay compensation to persons accepting offer if it makes a higher purchase offer in next 18 months.

The Guidelines recommend an offering period of 21 to 60 days, with extension of time in the event changes are made to the terms of the offering. Material facts should be publicized immediately. The offeror should not conclude any transactions in the target shares outside the offer, and in the case of an exchange offer should refrain from actions affecting the value of its own shares. Partial offers should be prorated.

FRANCE

1. Regulation

France has formally regulated tender offers only since 1970, when the Chambre Syndicale (the governing body of the stockbrokers' association) drew up rules regarding takeovers and the Commission des Operations de Bourse (the "COB" -- the government agency regulating the securities markets) adopted a code of practice for all public offers. 2/

Regulation of takeovers is exercised principally by these two bodies, but in certain circumstances two other bodies may be involved. The Finance Ministry has power to regulate foreign investment in France and the Committee for the Supervision of Takeover Bids, formed in 1978, may also make decisions on takeovers referred to it by its members.

The transactions to which tender offer regulation applies -- "public offers to purchase" and "public offers to exchange" -- are not specifically defined. Jurisdiction is also exercised over the transfer of "controlling interests", "control" being decided on a case-by-case basis. Gradual

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2/ The sources of tender offer regulation are the General Decisions of the COB concerning Public Offers (January 13, 1970, amended July 25, 1978) and a General Regulation of the Chambre Syndicale (August 8, 1973, amended August 7, 1978).

acquisitions do not appear to implicate the regulation of acquisitions of controlling interest.

2. Procedure and Filings

Two alternative procedures exist in a takeover. The offeror may purchase a "controlling interest" and follow up that purchase with a public offer to the target's shareholders, or it may make a takeover bid.

In the first instance, the offeror applies to the Chambre Syndicale, which determines whether the initial purchase is of a controlling interest. In the case that it is, the Chambre Syndicale will permit the initial purchase to be made if the offeror undertakes to purchase all the shares offered on the stock exchange over a period of 15 trading days. The Chambre Syndicale publishes a notice in the official stock exchange bulletin, giving the names of offeror and target, and the date, price and number of securities of the initial purchase. The term and price of the offer is also given. Apart from the initial application to the Chambre Syndicale, no filings are made.

A takeover bid is made by offer to all shareholders. The offeror must submit a "note d'information", or prospectus, for COB review and approval. A file regarding the offer is also submitted to the Chambre Syndicale by the financial institution guaranteeing financing for the offer. The Chambre Syndicale

pays close attention to the price offered, and the financial institution's justification of such price. When the Chambre Syndicale is satisfied as to the terms of the bid, and the COB has approved the prospectus, the Chambre Syndicale declares the bid effective and the terms of the bid are published by public notice. The offeror must make it clearly known that a prospectus cleared by the COB is available, and a statement to that effect must appear in all advertisements. The offeror, however, does not distribute its prospectus to shareholders.

In the case of foreign acquisitions of more than 20 percent of a company, the Finance Ministry can object on the grounds of public interest.

The target must submit a draft prospectus for COB approval within four trading days of publication of the Chambre Syndicale's notice. The target must circulate its prospectus to all its registered shareholders. Joint offeror/target prospectuses may be used.

A simplified procedure is available to an offeror who already holds most of the target's shares and wants to obtain the remainder. This cash or exchange offer for all the target shares must be open 20 trading days.

While offers may be conditional, the COB and Chambre Syndicale have given no indication of what type of conditions are likely to be acceptable.

3. Disclosure

No regulations as yet apply governing the information to be disseminated to shareholders in the purchase of a controlling interest.

In the case of a takeover bid, strict regulations apply. The offeror and the target must publish prospectuses subject to COB review. Shareholders receive the following information, either in joint prospectuses or from the offeror and target separately:

- The terms of the bid, including date of Chambre Syndicale's notice, term of offering, minimum number of shares on which offer is conditioned, number of shares to be purchased, conditions of offer;
- Object of the bid, reasons behind the bid and the offeror's intentions;
- Offeror's holdings of target's shares;
- Information necessary to assess price, including returns on shares, market price, other elements that offeror took into account;
- Remuneration paid to intermediaries;
- Target's board of directors' opinion of the merits of the bid for the company and for the shareholders, whether opinion is unanimous,

dissenters' opinion if they request its inclusion. Directors' holdings in target, whether they intend to accept bid as regards their own shares;

- Information regarding offeror, including principal shareholders, activities; principal subsidiaries and holdings, 5 years' financials with notes, recent business progress and results; and
- Information regarding target, including all information that would be required in a prospectus for shares issued by target. (Such information includes five years' financials, names of directors, target's business and recent changes and prospects.) Indication of how company capital allocated, including details of securities held by itself, details of arrangements concerning company securities, to the board's knowledge, which might affect the outcome of bid (particularly sale or purchase commitments, sales with repurchase option.)

4. Substantive Protection

<u>Minimum Offering Period</u>: In the purchase of a controlling interest, the offeror undertakes to purchase all shares on the

market over a period of 15 days. Takeover bid offers must be left open for at least a month.

All-holders: In the controlling interest procedure, the offeror undertakes to purchase all shares on the market. The takeover bid offer is made to all shareholders.

Best Price: In the controlling interest procedure, purchases must be made at the same price as that paid for the controlling interest itself. In a takeover bid, the offeror is required to offer the same price to all shareholders and to raise the offer price if it buys shares from the target and thus causes an increase in the market price, or if it deals in the market after the date upon which it may modify the offer price.

Withdrawal Rights: Shareholders have withdrawal rights until the last nine days of the offer.

Proration: Partial offers are permitted in takeover bids, but must be for at least 10 percent (5 percent if securities have high enough value) of equity capital. Proration is required.

Regulation of Purchases Outside Offer: Purchases outside the offer are not permitted during a takeover bid.

AUSTRALIA

Tender offers are a common acquisition technique in Australia, and have been regulated by statute since 1961. One purpose of the present regulatory scheme was to eliminate abuses under the previous regulation, such as changes in control without any offers being made for the shares of minority shareholders. The intent is to protect the interests of shareholders of target companies, by requiring adequate disclosure and time to consider an offer, as well as equal treatment of shareholders.

1. Regulation

Each state and territory (except the Northern Territory) of Australia has adopted substantially identical takeover legislation entitled the Companies (Acquisition of Shares) Code (the "Code"). Under the Code, most of the powers relating to the regulation of takeovers are conferred upon the National Companies and Securities Commission ("NCSC"). The NCSC delegates many of its powers to the Corporate Affairs Commissions ("CACs") of the various states. The Australian Associated Stock Exchanges ("AASE") also plays a part in the regulation of takeovers where the target securities are listed on the AASE exchanges, although the AASE rules on takeovers are now subordinate to the provisions of the Code.

Tender offer regulation applies to acquisitions (including exchange offers) that would result in the acquiror becoming entitled to more than 20 percent of the issued capital of a company, or increasing its ownership if it already owns more than 20 percent. Exceptions are provided, inter alia, for acquisitions approved by the target shareholders; acquisitions of not more than three percent of a company's voting shares in a period of six months; acquisitions of shares of very small companies; acquisitions made pursuant to a registered prospectus; and acquisitions made by will or operation of law. In the absence of such exemptions, regulated acquisitions of 20 percent or more of a company's securities may only be made in one of two ways: a takeover offer made under a "takeover scheme", or by a "takeover announcement" through a stock exchange. There are no rules affecting the acquisition of the first 20 percent of a company's voting securities although disclosure of holdings over ten percent is required.

2. Procedure and Filings

The takeover scheme is similar to a conventional United States tender offer. The offeror may offer cash or securities, and may seek all or only part of the target's shares. The offeror files a "Part A statement" with a copy of the proposed offer with the local CAC as the delegate of the NCSC, which will review and register the documents if they are acceptable.

The Part A statement must be delivered to the target and the stock exchange, if any, on which the target company's shares are listed, at least 14 but no more than 28 days before the offer document, which includes all information disclosed in the Part A statement, is disseminated to shareholders.

The target must furnish a recommendation (a "Part B Statement") to shareholders, either directly or by giving it to the offeror to send to shareholders along with the offer document; it is filed with the CAC upon distribution.

The offer may be conditional, but the Code prescribes the disclosures to be made regarding conditions and the manner of withdrawal. An offer may only be varied without the consent of the NCSC if the variation consists of extending the offer (although the offer cannot be open more than 12 months), increasing the consideration, or offering a cash alternative to an exchange offer.

The second acquisition procedure is the "take-over announcement." This method is not available to an offeror owning 30 percent or more of the voting shares unless the NCSC gives its consent. The offer must be for all shares of a class of stock of a listed company, and for a cash consideration. The announcement is made by a stockbroker on the floor of a stock exchange. The offer is effective 14 days after the date of the announcement. The offer price may be raised except during the last five trading days of the offer. If the price is raised, all offerees who have not sold their shares receive

the increased price, but those who sold previously do not. With the NCSC's consent, the offeror can lower the price if the target has devalued the shares, for example, by declaring a dividend. The circumstances under which the offer may be withdrawn are strictly regulated. The offer cannot be conditional.

No advance filing is required in a takeover announcement. On the day the announcement is made, the offeror delivers copies of a "Part C Statement" to the target company, the CAC and the exchange upon which the target shares are listed. Within 14 days of the announcement, the offeror sends a copy of the Part C Statement to each offeree shareholder. Also within 14 days, the target company furnishes copies of a recommendation statement (the "Part D Statement") to the offeror, stock exchange, and CAC. This statement does not have to be sent to the target's shareholders.

The same procedure applies for foreign offerors, although under the Foreign Takeovers Act the Treasurer of the Commonwealth of Australia, who is advised by the Foreign Investment Review Board, must be notified of investments by foreigners exceeding 15 percent of a company's shares, and may restrict such acquisitions on grounds of national interest.

The Code also provides for compulsory offers and acquisitions. Once an offeror becomes entitled to 90 percent of the target's shares, the remaining shareholders (as well as holders of non-voting shares, options and convertible notes)

must be given the opportunity to sell out at the offer price. This option must be open for three months, and the notice to the security holders must include a report of an independent expert stating that the terms are fair and reasonable. Correspondingly, a party holding 90 percent of the target as a result of an offer for all of the shares can buy out the remaining shareholders of the class for which the offer was made at the offer price.

3. Disclosure

While there are no extensive financial disclosure provisions or any financial statement requirements applicable to takeovers, it should be noted that companies legislation requires the ongoing disclosure and filing of financial information. The Part A Statement furnished by the offeror includes the following information:

- Period during which the offer is open;
- Names and addresses of directors, principal activities of corporation;
- Name and occupations of offerors who are natural persons;
- Offeror's holdings, recent dealings in target's securities, intentions regarding offers for classes of securities other than target shares;

- Where consideration includes offeror's securities, changes in offeror's (and its subsidiaries') capital structure in last 5 years;
- If consideration includes cash, source of financing;
- Details of any agreement made between offeror and target directors conditional on outcome of offer; any compensation for loss of office;
- Recent material changes, known to offeror, in target's financial position;
- Offeror's intentions regarding continuation of target's business, major changes to be made, future employment of target's employees;
- In an exchange offer, price information regarding securities offered, information about third-party issuer of exchange securities as if it were offeror; and
- Intentions to transfer target shares to other persons.

The Part B Statement furnished by the target includes:

- Directors' recommendations as to offer; dissenting directors' views;
- Details of directors' holdings of target's and offeror's securities;

- Whether directors holding shares intend to accept offer;
- Recent transactions by offeror and target in each other's shares;
- Compensation for loss of office, or upon transfer of target's property;
- Details of any other agreements in connection with outcome of offer;
- Interests of directors of target in contracts entered into by offeror;
- Recent price information as to target shares; and
- Recent material changes in target's financial position.

An independent expert's report is required in the Part B Statement where the offeror has connections with the target company (e.g., the offeror is a substantial shareholder of target, or there is a common director). This report must state whether in the expert's opinion the offer is fair and reasonable, and must set out reasons for such opinion.

The Part C Statement furnished by an on-market offeror includes:

- Names, addresses of directors, and principal activities of offeror;
- Details of offeror's holdings in target's

securities;

- Details of all recent transactions in target's and offeror's shares by offeror or its associates;
- Offeror's intentions to acquire additional target company securities, and the terms thereof; and
- Source of funds for consideration.

The Part D Statement furnished by the target company is very similar to the Part B Statement. No independent expert's report as to fairness is required.

4. Substantive Protections

<u>Minimum Offering Period</u>: An offer by takeover announcement is a standing offer to purchase shares for one month, extendable to six months. A takeover offer must last between one and six months (extendable to twelve).

<u>All-holders</u>: Offers under both takeover offers and takeover announcements must be extended to all shareholders of the class.

<u>Best Price</u>: In a takeover scheme, the same price must be offered for all shares. A "best price" provision also applies to an increase in consideration. If the offeror purchases shares on an exchange at a higher price than the offer price, the offer price must be increased accordingly. The price paid

in a takeover announcement must be at least the highest price paid for the securities in the last four months. Market purchases made during the offer at above the offer price will result in raising the offer price.

Withdrawal Rights: Except in the case of withdrawal upon extension of the offer period beyond six months, there is no statutory provision specifying circumstances in which a shareholder may withdraw his acceptance of an offer, whether or not it was unconditional. It is not clear whether a shareholder may withdraw his acceptance of an offer subject to conditions not yet fulfilled.

Proration: Partial offers are permitted in takeover offers. The offer must either be made in the same proportion to all shareholders, or purchases must be prorated. Partial offers are not permitted in takeover announcements.

Regulation of Purchases Outside Offer: Even though an intended takeover bid has been declared, shares may be acquired without restriction before the offeror reaches the prescribed threshold. Thereafter, it may lawfully acquire shares only on the market in the ordinary course of business, and then only if it has made an on-market takeover announcement or if the Part A Statement for a takeover scheme has been served. The right to purchase on the market during takeover schemes is restricted where the offer is subject to many conditions.

It should be noted that the NCSC has the power to declare an acquisition, or particular conduct during a takeover, to be

unacceptable. Such declarations are generally limited to circumstances where the offeree shareholders do not know the identity of an offeror, are given insufficient time or information to assess a proposal or are denied equal opportunity to participate in the benefits of the acquisition. The NCSC can apply to a court to impose sanctions in such cases.

SWITZERLAND

Switzerland does not regulate takeovers. The majority of Swiss companies are closely held, and thus even the general disclosure requirements for public companies are not applicable to most tender offers.

THE NETHERLANDS

1. Regulation

The Netherlands does not generally exercise control over mergers and acquisitions, but procedural provisions are embodied in a voluntary code. The Merger Conduct Rules (the "Rules"), which have no statutory basis, were promulgated in 1970 by the Social and Economic Council, an advisory body to the government composed of union, employer and government representatives. The Rules are administered by the Merger Panel, a body created by the Rules. They cover several types of acquisition, including tender offers, which are frequently used in the Netherlands.

While the Rules embody a voluntary code, they appear to be respected. Sanctions for their breach include a public censure, in which case stockbrokers are prohibited by their self-regulatory organization from participating in the offer.

The Rules apply to all offers for listed shares which are "made publicly known by the offeror" and include exchange offers. Offers made non-publicly to more than half the target's shareholders are also covered. Exemptions from the Rules may be granted. The Rules do not apply to market purchases or "creeping acquisitions" and there is no threshold at which a public offer is triggered.

2. Procedure

An offeror must first discuss the offer with the target's board. If any agreement is reached as to the offer, this must be disclosed promptly. As soon as possible thereafter, the offeror must draw up an offering document, and announce that it is available in the official gazette and other newspapers. Copies of the offering documents must be sent to the Merger Panel and the Amsterdam Stock Exchange. The stock exchange staff reviews the documents.

The directors of the offeror and target must submit to the Merger Panel statements of their and their affiliates' transactions in shares of the target (and the offeror, in the case of an exchange offer) within the last six months.

The target board must hold a shareholders' meeting at least eight days before the offer's termination date. Prior to the meeting, the board must distribute to the target shareholders a report setting out the board's position on the offer, with reasons. This document must also be submitted, at the time of publication, to the Merger Panel and the stock exchange.

The offeror must also call a shareholders' meeting in the case of exchange offers involving a substantial issuance of the offeror's securities.

The offeror may impose a limited number of conditions on its offer. Such conditions may include the acceptance of the

offer by a minimum number of shareholders, the continued absence of other offers and material changes warranting withdrawal, and approval by the Merger Panel.

There are no general restrictions that would prevent an offer by a foreign offeree, although the Central Bank must approve the acquisition of more than five percent of the shares of a bank. The procedure prescribed by the Rules applies equally to domestic and foreign offerors.

It should also be noted that the Rules prescribe employer/employee relations during acquisitions. Trade unions must be notified (in confidence) of merger negotiations and impending offers and given the opportunity to express their opinions.

3. Disclosure

Minimum contents of the offering document include:

- Business and financial information regarding both the offeror and the target;
- Terms of the offer, including price;
- Minimum number of shares offered for;
- Details of target's executive board and supervisory board's compensation after consummation of offer, compensation for loss of office;
- Details of any acquisitions of target shares made by offeror in last three years from target

directors or their associates, including price and justification of any difference between such price and the offer price; and

- Details of offeror's direct or indirect holdings in target shares, and target's holdings in offeror's shares.

The stock exchange may require further information.

4. Substantive Protection

<u>Minimum Offering Period</u>: In an agreed takeover, the offer must remain open for at least 20 days. In a hostile takeover, the offer must remain open for at least 30 days. The offeror must announce whether it accepts shares tendered within five days of the expiration of the offer.

<u>All-Holders</u>: Public offers must be made to all holders of the same class of securities.

<u>Best Price</u>: The same price must be offered to all security holders under the offer but purchases may be made outside the offer.

<u>Withdrawal Rights</u>: Tendering shareholders only possess rights of withdrawal in the event that the offeror postpones the date on which it is required to announce its acceptance of tendered shares.

<u>Proration</u>: Partial offers are not permitted.

Regulation of Purchases Outside Offer: The Rules allow purchases to be made on the stock exchange outside the offer.

C. SPECIAL COMPLIANCE ISSUES ENCOUNTERED BY FOREIGN BIDDERS UNDER UNITED STATES REGULATION OF TENDER OFFERS

The rules and regulations under the Williams Act do not provide for special consideration to be given to foreign bidders. Both domestic and foreign bidders must operate pursuant to the same substantive and disclosure provisions of the federal securities laws. In meeting those requirements, however, the foreign bidder may face disclosure issues which do not arise when a domestic bidder makes a tender offer.

1. Jurisdiction

In making an offer for an American corporation, a foreign bidder will normally subject itself to subject-matter jurisdiction as well as personal jurisdiction in United States courts. Similarly, where a foreign corporation's securities are traded in the United States, an offer for those securities

by a foreign bidder may invoke United States jurisdiction and the application of Williams Act. 3/

Application of the Williams Act to a tender offer by a foreign bidder will depend upon the facts in each transaction. In general, the courts have utilized two standards in determining if the federal securities laws have extraterritorial application: the conduct test, under which jurisdiction is predicated on conduct occurring within the United States; and the effects test, under which jurisdiction is predicated upon acts causing significant and foreseeable effects within the United States, regardless of where the conduct occurred. 4/ The courts have interpreted jurisdictional provisions broadly, "to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from

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3/ Under Commission Rule 3a12-3, 17 C.F.R. Section 240.3a12-3, securities of foreign private issuers registered with the Commission are exempt from the reporting and proxy provisions of the Exchange Act, but not the Williams Act provisions. Foreign private issuers whose securities are held by fewer than 300 U.S. residents or who furnish the Commission with certain reports, are exempt from registration with the Commission.

4/ *See* *IIT v. Cornfeld,* 619 F.2d 909, 918 (2d Cir. 1980); *Schoenbaum v. Firstbrook,* 405 F.2d 200, 208-09 (2d Cir.), 405 F. 2d 215 (2d Cir. 1968) (en banc rehearing on other grounds), *cert. denied,* 395 U.S. 906 (1969).

the effects of improper foreign transactions in American Securities." 5/

Where the number of United States holders of the foreign corporation's securities is not substantial, a foreign bidder can avoid United States jurisdiction and the application of the federal securities laws by minimizing the conduct in the United States concerning the offer by, for example, not mailing the offer into the United States, not accepting any securities tendered from within the United States, and utilizing depository and transfer agents not located in the United States. The Court of Appeals for the Second Circuit has held that there is "no reason to extend jurisdiction to cases where United States activities ... are relatively small in comparison to those abroad." 6/

In Plessey Company PLC v. General Electric Company PLC, 7/ the district court held that the Williams Act did not apply to an exchange offer by a British company for the securities of another British company, even though the target corporation's securities were registered with the Commission and traded on the New York Stock Exchange. The offer expressly excluded

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5/ Schoenbaum v. Firstbrook, 405 F. 2d at 206.

6/ IIT v. Cornfeld, 619 F.2d at 920, citing Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 987 (2d Cir.), cert. denied, 423 U.S. 1018 (1975).

7/ 628 F.Supp. 477 (D. Del. 1986).

United States holders and was structured to avoid the United States jurisdictional means by prohibiting the mailing of materials into the United States and the acceptance of shares tendered in an envelope postmarked from the United States. In addition, the American press was excluded from press conferences and were not provided copies of the press releases. The court found this factor significant, even though the offer was immediately and widely reported in the United States press. Of particular significance was the predominately foreign nature of the offer: 98.4 percent of the target's potential voting shares were in the hands of non-United States residents.

Foreign bidders conducting tender offers for the shares of foreign corporations which have United States shareholders often prefer to give foreign shareholders an election to receive either cash or securities of the bidder but, to avoid filing a 1933 Act registration statement in the United States, restrict United States shareholders to receiving only cash. In such situations, the question has arisen whether the offer to United States shareholders, even though limited to cash, constitutes an "offer to sell" securities within the meaning of Sections 2(3) and 5 of the 1933 Act. The staff has taken the position that it does not comprise such an "offer to sell" provided full and conspicuous disclosure is made that the securities are not being offered to United States shareholders

and adequate safeguards are implemented to assure that no United States shareholder receives any of the securities. 8/

Because of the laws of other countries, this solution may not always be workable. The staff has also issued no action letters relating to the use of "vendor placings," which are often employed in acquisitions of British companies. In a vendor placing, the offeror issues its own securities to the shareholders of the acquired company, called "the vendors," in return for their shares. At the same time, the vendors renounce their right to the acquiror's shares in favor of the acquiror, which sells the shares on behalf of the vendors and remits the money to them. The shares are sold in such a manner that they "come to rest" outside the United States. The staff has taken the position that the shares issued by the acquiror to the vendors do not have to be registered pursuant to the Securities Act in light of the fact that the shareholders of

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8/ Alberta Energy Ltd. (July 19, 1982); Jamaica National Investment Company Ltd. (November 29, 1979.) Where an offer involves sufficient conduct or effects in the United States to be subject to the Williams Act, any condition excluding shareholders in a particular country would violate the Commission's "All Holders-Best Price" rules, found at Rules 14d-10 and 13e-4(f)(8). *See* Securities Exchange Act Release No. 23421 (July 11, 1986). Similarly, attempts to provide United States holders an alternative form of consideration are now governed by those rules. The Commission will, however, consider requests for exemptive relief from those provisions on a case-by-case basis. *Id*.

the company being acquired (i.e., the vendors) receive only cash and are not entitled to retain the acquiror's shares. 9/

2. Financial Information

One of the most difficult areas for a foreign bidder relates to the nature and extent of financial information required to be disclosed by the bidders. The financial statement requirements for bidders are set forth in Item 9 of Schedule 14D-1, which requires financial statements, if that bidder's "financial condition is material to a decision by a security holder whether to sell, tender or hold" the security sought in the tender offer. The financial condition of a bidder is considered "material" to the shareholders where the bidder does not otherwise file publicly available financial information and is seeking a majority or other controlling interest of a subject company. 10/ Also relevant to the determination of the materiality of the financial condition of

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9/ See e.g., Electrocomponents PLC (Sept. 23, 1982); Cambrior, Inc. (June 22, 1987); Oldcastle, Inc. (July 3, 1986).

10/ See Corenco Corp. v. Schiavone & Sons, Inc., 362 F.Supp. 939, 948-50 (S.D.N.Y.), aff'd in part, 488 F.2d 207 (2d Cir. 1973); Prudent Real Estate Trust v. John Camp Realty, Inc., 599 F.2d 1140 (2d Cir. 1979).

the bidder, is the ability of the bidder to finance the acquisition. 11/

In Life Investors, Inc. v. AGO Holding, N.V., 12/ a Netherlands corporation sought 15 percent of the outstanding stock of an American insurance company. In holding that the bidder's financial statements were material, the Court of Appeals for the Eighth Circuit focused on the fact that the tender offer, although limited to approximately 15 percent of the outstanding stock, was an amount sufficient to permit it to exercise control, but nevertheless created a minority class of shareholders retaining 40 percent of the company. The court also noted that the foreign bidder was not otherwise subject to United States disclosure obligations.

Assuming the financial condition of the foreign bidder is deemed material, "adequate" financial information concerning the bidder 13/ must be disclosed in the Schedule. Additionally, pursuant to Rule 14d-6(e)(viii), the offering

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11/ See Securities Exchange Act Release No. 13787 (July 21, 1977).

12/ [1981] CCH Fed. Sec. L. Rep. Para. 98,356 (8th Cir. 1981).

13/ If the bidder is controlled by another entity which is not a natural person and has been formed by the parent for the purpose of making the tender offer, current adequate financial information concerning such parent would be required by Item 9 of the Schedule.

circular disseminated to shareholders must contain either the disclosure required by the Item or a fair and adequate summary thereof.

To provide guidance to bidders as to what constitutes current adequate financial information, Instruction 1 to Item 9 sets forth the type of financial information which would be deemed adequate for purposes of the item. The "safe harbor" provided by Instruction 1 is premised on the nature of the bidder. For foreign bidders, financial statements prepared in compliance with Form 20-F, if the bidder would be eligible to use such form, would be sufficient. For the purpose of limiting the possible burdens on bidders who are not subject to the periodic reporting requirements of the Exchange Act, Instruction 3 to the Item permits the use of unaudited financial statements if audited statements are not available or obtainable without unreasonable cost or expense. If a bidder relies upon this instruction, the bidder must include a statement to that effect and disclose the reasons therefor in its response to Item 9.

Not only must a foreign company's financial information be presented in response to Item 9 of the Schedule, that information must be presented in a manner that is meaningful to the United States security holder so that an informed investment decision can be made. Accordingly, the staff has taken the position that disclosure of a bidder's financial information expressed in foreign currency terms is deemed not

responsive to the Item requirement unless that information is accompanied with appropriate disclosure of the bidder's accounting practices together with the identification and, if practicable, quantification of any material variation in those accounting practices from United States GAAP and the form and content of Regulation S-X.

3. Disclosure of Foreign Regulatory Requirements And Controlling Persons

Another issue creating special concerns for the foreign bidder relates to foreign law. Item 10(b) of Schedule 14D-1 requires, where material and to the extent known by the bidder after reasonable investigation, disclosure of any "regulatory requirements which must be complied with or approvals which must be obtained in connection with the tender offer." In addition to securing approval from certain United States regulatory agencies, a foreign bidder might also be subject to regulatory controls emanating from its home country. This would include the obtaining of consents under exchange control regulations. Moreover, certain foreign jurisdictions may place restrictions on the manner in which a company controls a foreign entity. 14/ Such restrictions must be adequately

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14/ See General American Host Corporation v. Triumph American, Inc., 359 F.Supp. 749 (S.D.N.Y. 1973), wherein the court states that "[f]oreign controls,
(continued . . .)

disclosed. Conflicts also arise when foreign law forbids the disclosure of certain information required to be disclosed pursuant to Schedule 14D-1 and disseminated to shareholders in accordance with Rule 14d-6(e)(1)(vii). 15/

(. . . continued)
particularly when they differ in extent and kind from controls the United States investor has come to expect from the United States government in relation to domestic operations, are matters which should be called to the attention of shareholders in a tender offer.

15/ In one such situation, a Canadian bidder was making a cash tender offer to United States shareholders of another Canadian company. The bidder had borrowed funds for the offer from a Canadian chartered bank. The Canadian bank was not a "bank" as defined in Section 3(a)(6) of the Exchange Act and, accordingly, the bidder was required by Item 4 of Schedule 14D-1 and Rule 14d-6(e)(1)(vii) to disclose the name of the bank in the offering circular. Counsel for the bidder, however, represented that such disclosure would violate Section 310(2) of the Bank Act (Canada), which states that "(e)very person who uses the name of a bank or a foreign bank in a prospectus or advertisement for a transaction related to securities . . . is guilty of an offense against this Act . . ." In order to permit the bidder to comply with this Canadian legal requirement and at the same time make the name of the bank available to persons in the United States who may wish to know it, the staff issued a "no-action" position to the bidder indicating that the bidder need not identify the bank by name in the offering circular, provided the bank was named in response to Item 4 of Schedule 14D-1; a complete copy of the loan agreement was filed as an exhibit to the Schedule; all material facts regarding the loan, other than the name of the bank, were disclosed in the offering circular; and the offering circular contains a statement that the name of the bank has been disclosed in the Schedule 14D-1 filed with the Commission. Alberta Energy Ltd. (July 19, 1982).

Item 2 of Schedule 14D-1 calls for, inter alia, the identity of the offeror and its place of organization and principal business. This information must also be given with respect to each person controlling the offeror. This can raise special problems for the foreign corporation, since identification of the controlling persons of a foreign bidder may be obscured by holding companies or by the existence of bearer shares. 16/

4. United States Regulatory Restrictions on Foreign Acquisitions

A significant restriction on tender offers that applies to foreign and domestic bidders alike, is the United States antitrust laws. These laws apply to foreign companies if they do business in the United States or if their activities have an effect on United States commerce.

The Hart-Scott-Rodino Antitrust Improvement Act of 1976 imposes a waiting period on all acquisitions meeting certain threshold requirements to allow officials at the Department of Justice and the Federal Trade Commission to examine the antitrust implications of the takeover. The Act contains

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16/ See Ronson Corporation v. Liquifin Aktiengesellschaft, 483 F.2d 846 (3rd Cir. 1973).

several exemptions, including Section 802.51 of the rules, 17/ which deals with acquisitions by foreign persons. Under that rule, the acquisition by a foreign company of a United States company with annual net sales and total assets of $25 million or less is exempt from the reporting requirements and the waiting period. Acquisitions by a foreign company of another foreign company is also exempt if the sales and assets of the two companies in the United States total less than $110 million.

Restricted Industries: There are a number of federal and state statutes that prohibit or restrict the ability of foreign corporations to acquire control or to exceed a specific ownership interest in certain industries. 18/ These include banking, communication, shipping, nuclear energy, defense industries, and mineral and natural resources. If the restricted industry constitutes only a limited portion of the subject company's operations, the bidder might be able to resolve its regulatory problems by divesting itself of the restricted industry or placing the restricted industry in the hands of an independent trustee pending federal agency

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17/ 16 C.F.R. Section 802.51.

18/ See Fleischer & Feder, Special Problems of Foreign Bidders in Acquisitions by Tender Offer, 1 J. Comp. Corp. L. & Sec. Reg. 349, 353 (1978).

approval. 19/ For the most part, however, the United States historically has encouraged foreign investment in this country. 20/

19/ Id., at 353.

20/ See Berger, Applying Uniform Margin Requirements to Foreign Entities Attempting to Acquire U.S. Corporations, 24 Va. J. Int'l L. 543 (1984).

VI. ISSUES RAISED BY INTERNATIONAL OR MULTINATIONAL SECURITIES OFFERINGS

Securities markets around the world are changing as foreign issuers expand their use of United States capital markets, domestic issuers access foreign markets and both debt and equity offerings are made multinationally. As a result of these offerings, the lines of demarcation between domestic and international capital markets are beginning to blur and domestic markets are facing serious competition from a largely unregulated, transnational financial market.

The changes in these lines raise numerous issues under United States securities laws for domestic issuers raising capital offshore and foreign issuers selling to United States investors, at home or abroad. Questions concerning the extraterritorial application of Section 5 of the Securities Act have resulted in complex and costly offering procedures to assure that registration provisions do not apply, as well as the exclusion of United States persons from various offshore investment opportunities. Yet, large offshore trading markets have developed, where United States investors who choose to buy unregistered securities are free to do so, but only after certain periods of time following an offering of the securities. This distinction has on occasion proved costly to United States investors.

Foreign issuers that consider directly accessing the United States capital markets through registered public offerings are frequently dissuaded by the substantial differences in disclosure requirements, particularly with respect to accounting principles and auditing standards. As registration under the Securities Act brings with it a periodic reporting requirement under the Securities Exchange Act, a foreign issuer deciding whether to register securities must also consider the continuing reporting costs. Concerns about liability provisions, perceptions of a litigious environment and submission to SEC oversight also contribute to foreign issuers' reluctance to enter voluntarily the United States securities markets.

The challenge is to remove unnecessary impediments to transnational capital formation, while assuring that those buying securities in the United States capital markets are afforded the protections intended by the Securities Act and the Securities Exchange Act. Care needs to be taken as an integral part of this effort to avoid accommodations to foreign corporate practices and laws that unduly advantage foreign issuers over domestic issuers.

A. EXTRATERRITORIAL APPLICATION OF UNITED STATES LAW

1. Redefining the Reach of Section 5

For companies raising capital abroad, the principal issue under the federal securities laws is the reach of the registration requirements under Section 5 of the Securities Act across national boundaries. As early as 1964, the Commission recognized that application of the registration provisions of Section 5 of the Securities Act should be more restricted than the Act's full jurisdictional reach. 1/ The Commission has not sought to apply the registration provisions to transactions using jurisdictional means but not involving United States persons or markets. In certain circumstances, even sales to non-United States persons made within United States markets have been considered beyond the scope of the registration provisions. 2/ However, the demarcation of the appropriate reach of Section 5 has not been definitively determined. While the issue has existed for many years, it has become of critical importance with the development and maturity of major markets offshore and the huge growth of transnational investment. In defining the

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1/ Securities Act Release No. 4708; 29 Fed. Reg. 9828 (July 1, 1964). In that release, the Commission took the position that it would not take enforcement action if securities are sold under circumstances reasonably designed to prevent the distribution or redistribution of the securities into the United States or to United States persons.

2/ *See, e.g.*, *Israel Discount Bank* (July 23 and Sept. 13, 1981); *Bank Leumi* (May 7, 1982).

jurisdictional ambit of registration, the implication of the secondary trading markets must be fully considered. Sales of securities abroad by an issuer may raise Section 5 questions, while sales of these same securities a few months later in the secondary market do not implicate the United States securities laws at all. This dichotomy occurs because, pursuant to the Securities Act, registration is generally required for offers or sales of new offerings of securities by issuers or affiliates, while secondary trades are exempt from registration under the Securities Act. The Securities Exchange Act, which requires periodic reporting of information by issuers with securities traded in United States markets, does not extend to foreign securities traded only in foreign markets. 3/

3/ Pursuant to Sections 12(b) and 12(g) of the Securities Exchange Act, 15 U.S.C. Section 78l(b), (g), issuers with securities registered on a national securities exchange, or engaged in interstate commerce, in a business affecting interstate commerce or with securities traded by use of any instrumentality of interstate commerce and with more than 500 shareholders of record and $5 million in assets, must register those securities under the Exchange Act. Foreign issuers with fewer than 300 United States security holders are exempt from the provisions of Section 12(g). In addition, foreign issuers whose securities are not traded on an exchange or quoted on NASDAQ may claim an exemption from Section 12(g) pursuant to Rule 12g3-2(b), 17 CFR Section 240.12g3-2(b), if they file with the SEC the documents they are required to make public in their home jurisdiction. Certain issuers whose securities were quoted on NASDAQ prior to October 5, 1983, may also rely on the exemption.

This free accessability of United States persons to securities in the foreign secondary markets causes a problem for United States investors when foreign issuers make rights or exchange offers. United States investors have made purchases in offshore trading markets in great volume. As a result, there are a number of foreign companies that have never voluntarily entered the United States securities markets, but whose securities are held by United States persons in the United States. Those holding foreign securities originally purchased in foreign secondary markets may be precluded from participating in rights or exchange offerings because the foreign issuer is reluctant to register the offerings as is generally required by the Securities Act. Rather than registering the securities, the foreign issuer either excludes United States holders or provides them cash instead of securities. Either alternative can be costly to United States holders.

The recent development of active international trading markets and the significant increase in offshore offerings of securities, as well as the significant participation by United States investors in foreign markets, have heightened the need to revisit the parameters of the registration provisions in order to address these inconsistencies. 4/

4/ The problems raised by application of United States registration requirements in a foreign context are illustrated by the following situation recently addressed by the Commission. In connection with a

As the international markets have expanded, the differing treatment of United States persons in primary and secondary markets has become more pronounced and has affected a large number of persons. United States investors have expressed discontent with their exclusion from investment opportunities caused by application of the securities registration requirements to foreign issues. Issuers, both domestic and foreign, have been dissatisfied with the complex procedures required to assure that securities sold

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number of recent registered offerings by foreign companies, a question was raised as to whether continuous registration would be required because affiliates of the issuer engaged in market-making activities in the foreign markets, and persons purchasing in the foreign markets for resale into the United States might be underwriters. See Section

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(. . . continued)

2(11) of the Securities Act, 15 U.S.C. Section 77b(11). If registration were required, a foreign issuer whose affiliate is conducting activities solely in a foreign jurisdiction would be required to register securities in the United States solely because a United States market for the securities exists. The Commission decided not to apply the registration requirements, however, if the issuer is a foreign company with securities registered under the Exchange Act, its principal market is in a foreign country and not more than 20 percent of its average trading volume is in the United States. In addition, disclosure of the market participation was required to be included in filings made under the Securities Act and the Exchange Act; there could be no special selling efforts in the United States targeted to effect a distribution in this country and sales by the affiliate were required to be made in the normal course of market activities recognized as legal and appropriate in the issuer's home country.

abroad are not sold or resold to United States persons. 5/ As a matter of comity, it is questionable whether United States laws should require foreign issuers making primary offerings in foreign markets in accordance with the laws of that foreign jurisdiction to take extensive precautions to assure the securities are not sold to United States persons, as often happens.

There appears to be a broad-based consensus that Section 5 properly applies to offerings made in the United States capital markets. 6/ This territorial approach to the regulatory provisions of the Securities Act is consistent with the regulatory ambit of the Securities Exchange Act and with comity principles. Such an approach recognizes the primacy of the laws in which a market is located. As investors choose their markets, they would choose the laws applicable to such markets. Such an approach does not, however, affect the broad reach of

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5/ *See, e.g.*, *Proctor & Gamble* (Feb. 21, 1975), outlining the procedures followed for Eurobond offerings.

6/ For example, in February 1987, the Commission held a roundtable with representatives of the bar, issuers, investors and securities professionals to discuss internationalization of the securities markets. The participants favored the territorial approach.

antifraud provisions of either the Securities Act or the Securities Exchange Act as presently applied. 7/

Pursuant to the territorial approach, United States securities laws would protect all participants in the United States capital markets, including foreign persons in the United States. The distinction between treatment of United States investors when they purchase in primary offerings and when they purchase in foreign secondary markets would be greatly reduced, because the primary consideration in applying United States disclosure regulations to sales in the primary and secondary markets would be whether the offer or sale is made within the United States. Offshore offerings targeted at United States investors or intended to evade United States securities laws would continue to be fully regulated.

With respect to issuers, both domestic and foreign, which offer securities abroad and have active United States trading, the periodic reporting requirements of the Securities Exchange Act can assure that United States investors who buy securities offered abroad that flow back to the United States are provided the same information that would be provided by the registration process. The integrated disclosure system for domestic, as well as foreign, companies that file Securities Exchange Act

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7/ *See* discussion in Chapter VII, *infra*.

reports already permits seasoned companies to incorporate by reference Securities Exchange Act reports into Securities Act filings. 8/ The territorial approach would place even greater reliance on the periodic reporting system mandated by the Securities Exchange Act.

In defining a territorial approach, the concept of an "offer or sale within the United States" must be developed, taking into account advancing technology and worldwide telecommunications. Clear, simple guidelines designed to assure that investors in United States capital markets have appropriate information available to them must be established, taking into account the differences in debt and equity offerings 9/ as well as the differences in the types of purchasers that may be involved. 10/

8/ See Forms S-2, S-3, F-2 and F-3. 17 CFR Section 239.12, .13, .32 and .33.

9/ Differences between debt and equity have often been recognized in setting disclosure requirements. For example, issuers that file reports under the Exchange Act may incorporate those reports by reference into Securities Act filings when selling investment grade debt, while incorporation by reference is permitted for primary issuances of equity securities only if certain other tests are met. See Form S-3; Instr. I.B.; 17 CFR Section 239.13.

10/ Congress recognized a distinction between institutional and sophisticated investors on the one hand, and the investing public on the other, when enacting the Securities Act. See Landis, "The Legislative History of the Securities Act of 1933," 28 G. Wash. L. Rev. 29, 37 (1959). This distinction has subsequently been recognized by the Commission

2. Recent Interpretations

Several recent interpretive and no-action letters address issues raised by the transnational trading of securities. For example, a letter to College Retirement Equities Fund ("CREF"), 11/ addressed the concern of United States institutional investors that they were being excluded from foreign offerings, even though they should have been able to purchase in a private placement exempt from registration under the Securities Act. Foreign issuers excluded these institutions to avoid any question about the application of the registration provisions to the offshore offering. While the Commission in earlier releases had indicated that the private placement and offshore offering would not be integrated, foreign issuers remained concerned. The staff issued this interpretive letter to squarely address the issue and stated that offshore offerings made to non-United States persons will not be integrated with private placements. The letter made clear that the foreign issuers

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and the staff in various contexts. See, e.g., Securities Act Releases No. 6188, 45 Fed. Reg. 8960 (Feb. 11, 1980) and 6508, 49 Fed. Reg. 5920 (Feb. 10, 1984).

11/ Feb. 18, 1987.

would not be required to take any precautions to assure that the foreign portion would come to rest abroad in addition to those, if any, they would take if the United States placement were not made. A similar letter was issued to CREF on June 4, 1987, relating to CREF's ability to participate in rights offerings and exchange offers.

In the first letter to CREF the staff also stated its view that the securities purchased by United States institutions could be resold onto the Paris Bourse without inquiry as to the citizenship or residence of the purchaser on the Bourse, provided sales were made in regular way transactions. In view of the limited United States investor participation on the Bourse, such a resale, which would not be directed at United States persons, does not call for application of the registration provisions.

Counsel for the French Government requested a no-action position respecting the French privatization program in which substantial interests in entities held by the French Government are being sold to the public. The French had concerns similar to those expressed in the CREF letters that, if a United States private placement were made as part of a privatization offering, additional procedures would be required to assure that sales would not be made to United States persons as part of the foreign offering. Additionally, the procedures mandated by French law required that offers be made to all French residents

without regard to citizenship. As a result, there was a concern that the registration requirements of the Securities Act could be violated by unregistered sales to United States citizens residing in France. The staff stated it was of the view that the United States private placements would be considered separate from the French portions of the offerings and additional procedures would not be required in the French offerings to assure sales were not made to United States persons. In addition, in view of the mandate by French law to sell to United States persons, the staff stated it would not take action if the French portions of the offerings were carried out as required by French law even though sales might be made to United States citizens residing in France. 12/

B. ACCESS TO UNITED STATES MARKETS BY FOREIGN ISSUERS

Facilitating foreign issuers' direct access to the United States capital markets presents far more difficult challenges. The needs of investors in the United States markets are largely the same whether the issuer is domestic or foreign. The costs of compliance for selling the same type of securities to the same class of investors should not be significantly greater for domestic public companies

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12/ French Privatization Program (Apr. 17, 1987).

than for foreign companies. Whatever modifications in disclosure requirements are made to recognize home country laws and practices, the liabilities for such disclosure are provided by the Securities Act and Securities Exchange Act and apply equally to foreign and domestic issuers. Nonetheless, foreign issuers' reluctance to access the United States markets cannot simply be dismissed. United States investors want to purchase such securities and will go offshore to do so. This can adversely affect the ability of United States markets to compete with foreign markets as well as be costly to United States investors.

Central to the United States disclosure system are the required financial statements and related financial disclosure. Differences in accounting principles, auditing standards and auditor independence standards are the principal impediments to foreign issuers' publicly offering securities in the United States. Reconciliation of foreign accounting disclosure to United States accounting principles can be done, but may be time consuming and costly. Compliance with auditing standards can be very costly, and if it has not been done in past periods, may not be possible. Nonetheless, since the accounting principles and auditing standards are at the core of the disclosure system, accommodation of foreign standards and practice has been limited pending evolution of

international accounting and auditing standards. That process is ongoing. 13/

Foreign issuers also have raised concerns about liabilities imposed by the United States securities laws and about submission to the jurisdiction of the SEC. Perhaps these concerns will lessen as home country markets mature, home country regulatory bodies become more active and mutual surveillance and enforcement agreements are developed and used. 14/

As an initial, experimental effort the Commission is developing a proposal for reciprocal disclosure for the registration of specified securities. The reciprocal registration statement forms would use the offering document required in an issuer's home country as the prospectus for offerings in the United States. 15/ The key to implementation of the approach is accounting principles and auditing standards. If a reciprocal approach is adopted, these areas will be central in determining which

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13/ *See* discussion in Chapter IV, *infra*.

14/ *See* discussion in Chapter VII, *infra*.

15/ Of course, the offeror must comply with any state law requirements that may be applicable.

jurisdictions should be included and what classes of issuers and types of securities should be permitted.

The Commission proposed initially to implement the reciprocal approach with the United Kingdom and Canada, because the disclosure and accounting practices of those countries are most similar to those of the United States, and because of familiarity with those countries' standards due to the frequency of their issuers' filings in the United States. 16/ Reciprocal registration would apply primarily to world class issuers of investment grade debt, because those securities would trade, in large part, on yield and rating. Thus, reconciliation of accounting and auditing from the home country presentation would not be essential. In addition, limited rights offers and exchange offers may be permitted on these forms. Extending reciprocal registration to rights and exchange offers by a non-reporting foreign issuer with limited United States security holders is intended to encourage the inclusion of United States investors in such offers by facilitating the registration process. As noted above, currently United States investors are simply excluded or cashed out.

Other rulemaking efforts, not directly targeted at international issues, also may affect foreign issuers' access to the market. Small issuer exemptions under

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16/ Securities Act Release No. 33-6568 (Feb. 28, 1985).

Section 3(b) of the Securities Act, in addition to helping small issuers in the United States, may provide assistance to foreign issuers with United States employees or security holders. The Commission recently proposed Rule 701, which would exempt offerings of securities to employees under compensation plans or contracts up to $5 million if the issuer is a non-reporting company. 17/

Similarly, the staff is considering proposal of an exemptive rule under Section 3(b) of the Securities Act for rights offerings and possibly for exchange offerings of less than $5 million made by non-reporting companies. Such a rule may be useful to enable United States persons to participate in certain categories of offerings made by issuers organized in countries not party to reciprocal forms or by issuers that may be reluctant to use the forms.

A contemplated codification of interpretations under the Securities Act to clarify when institutions may resell unregistered securities to other institutions may reduce the cost of private placements. This may encourage foreign issuers to access the United States through the private placement mechanism.

17/ Securities Act Release No. 6683, 52 Fed. Reg. 3015 (Jan. 16, 1987).

A key factor in facilitating foreign issuers' access to the United States capital markets is a coordinated effort with state securities regulators. Foreign issuers entering the United States capital markets must be equally concerned with the requirements of state securities laws. Discussion has been undertaken between the SEC staff and representatives of state securities regulators.

These issues will continue to be considered as the internationalization process continues.

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CHAPTER IV

Accounting and Auditing Standards in Relation to Multinational and International Issues of Securities

Prepared by the Office of the Chief Accountant

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CHAPTER IV

ACCOUNTING AND AUDITING STANDARDS IN RELATION TO MULTINATIONAL AND INTERNATIONAL ISSUES OF SECURITIES

A. Introduction

The accounting and auditing concepts discussed in this chapter concentrate on the United States, Canada, the Member Countries of the European Economic Community (EEC), and Japan. The markets in these countries account for the greater part of securities trading in the world today.

B. Standard Setting - Accounting Principles

The manner in which accounting principles are established varies between countries. Accounting principles are promulgated either by governmental bodies, private standard setting bodies, or a combination of the two. There are reasons for the different approaches to standard setting, including legal, cultural, economic and political. One factor that seems to have played a more significant role than others is the degree of diversity of ownership interests in business enterprises in a country. 1/ Where corporate ownership is conce trated in the hands of a few institutional holders, or where family held businesses predominate, there is often less impetus for the development of comprehensive, sophisticated financial reporting systems. Consequently, accounting professions in those countries may be less advanced and have less influence in the standard-setting processes. To the extent that

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1/ John N. Turner, "International Harmonization: A Professional Goal," Journal of Accountancy (New York, NY: American Institute of Certified Public Accountants-(January, 1983)), 60.

there are generally accepted accounting principles and practices in those countries, they are promulgated largely by governmental agencies and embodied in various company laws or other statutes that are often driven by the information needs of the public sector. On the other hand, where corporate ownership is more diverse, audited financial statements take on much greater significance, and this in turn increases the influence of private sector bodies. In the United Kingdom and Australia, for example, accounting principles are broadly stated in company law and amplified through standards established by the accounting profession, generally under the oversight and with the backing of governmental entities. And, at the federal level in Canada, relevant statutory provisions defer to the recommendation of the Canadian Institute of Chartered Accountants for authoritative accounting standards.

1. Private Sector Standard Setting

Standard setting in the private sector is best illustrated by the process in the U.S. Although the government, through the SEC, does have the authority to set accounting standards, in general accounting principles are established in the private sector. 2/ The Financial Accounting Standards Board (FASB) is

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2/ A detailed description of the process is contained in the "Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission Before the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce," dated March 6, 1985.

recognized by the SEC as the private sector body having the designated authority to establish standards of financial accounting and reporting. The resulting general purpose financial statements are designed for investors and other users seeking timely, reliable information that fairly presents operating results and financial position.

In 1938, the SEC stated its policy, in Accounting Series Release (ASR) No. 4, that financial statements filed with the Commission, for which there was no substantial authoritative support, would be presumed to be misleading. This policy encouraged the accounting profession to establish standards narrowing the areas of difference in accounting practices. 3/ And, in 1938, the American Institute of Certified Public Accountants (AICPA) created the Committee on Accounting Procedure. This Committee was followed by the Accounting Principles Board (APB) in 1958, and, because of the APB's inability to narrow alternative accounting standards, 4/ by the FASB in 1972.

3/ John C. Burton, Russel E. Palmer and Robert S. Kay, Handbook of Accounting and Auditing (Boston: Warren, Gorham & Lamont, 1981), 41-8.

4/ Bruce Bublitz and Robert Kee, "Do We Need Sunset Requirements for FASB Pronouncements?" Journal of Accounting, Auditing and Finance (Winter 1984): 123

The SEC reiterated its policy of reliance on the private sector in ASR No. 150 upon creation of the FASB. The release stated, in part:

> "... the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors."

The FASB follows a multi-step process in developing an accounting standard, similar to the rule-making procedures used by government agencies. Initially, in-depth research is done. Typically, this is followed by a discussion memorandum, exposure draft, the receipt and review of comment letters from interested parties, public hearings, and the final promulgation of a standard. 5/

Although the Commission's expressed policy is to rely on the private sector for standard setting, the Commission has significant influenced that process. The Commission exerts its influence throu various programs, such as: rulemaking initiatives which supplement accounting standards, implement financial disclosure requirements and establish independence criteria for accountants; 6/ the review

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5/ The Board also issues pronouncements other than standards (namely, interpretations and technical bulletins), following somewhat less extensive procedures.

6/ Many times these initiatives have triggered standard setting in the private sector. Example include lease disclosure, the moratoriums on the capitalization of interest and computer software costs, inflation accounting, and the development of supplemental oil and gas disclosures.

and comment process which results in improvement of filings, identification of emerging accounting issues (which can result in rulemaking or private sector standard-setting), and identification of problems warranting enforcement actions; the enforcement program, which imposes legal sanctions and serves to deter irregularities by enhancing the care with which registrants and their accountants analyze accounting issues; and oversight of private sector efforts to establish accounting and auditing standards and to improve the quality of audit practice. 7/

The SEC imposes requirements as to form and content of financial statements in addition to those required by generally accepted accounting principles (GAAP). These requirements are contained in Regulation S-X, 8/ which addresses those areas (generally disclosure as opposed to measurement principles) where GAAP is not explicit. 9/ Commission interpretative Financial Reporting Releases and Staff Accounting Bulletins issued by the Commission's staff also address areas where GAAP is not express.

2. Statutory Standard Setting

There are several problems that may result from the establishment of accounting principles by governmental bodies. First,

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7/ U.S. Securities and Exchange Commission 1986 Annual Report.

8/ Chapter II, Title 17 of the Code of Federal Regulations, Part 210.

9/ ASR No. 280 (September 2, 1980).

tax regulations tend to influence the presentation of financial statements. This can be a significant factor in countries where the financial statements generally must agree with the tax returns. Because the objectives of fiscal authorities often conflict with the needs of investors, this conformity requirement often frustrates the fair presentation of financial condition and operating results. This is the situation in Japan, where government influence on business can be described as both pervasive and supportive. 10/ The Japanese government exercises its accounting standard setting authority through tax regulation, the Commercial Code, and the Securities and Exchange Law. 11/

Under the tax regulations in Japan (and some other statutory countries), companies must incorporate special reserves in the financial statements in order to deduct them for tax purposes. The special reserves cause a distorted presentation of the financial statements and so would not appear in a balance sheet of a U.S. reporting entity. 12/ The Commercial Code, administered by the

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10/ Leslie G. Campbell, Accounting and Financial Reporting in Japan (London: Lafferty Publications Ltd., 1985), 70

Interestingly, Japan is an exception to the general observation that statutory standard setting is most likely in countries where ownership of companies is concentrated in the hands of a few. Japanese individuals own a significant equity interest in listed Japanese companies. The 1984 Fact Book of the Tokyo Stock Exchange (P.41) places that ownership at 28% at the end of 1983. Japanese businesses accept government intervention as legitimate and necessary.

11/ Id. at 4.

12/ Id. at 5.

Ministry of Justice, is designed to emphasize the protection of creditors over that of investors. Accordingly, net worth and balance sheet strength are stressed over income measurement. 13/

Japan also has a Securities and Exchange Law which is in many respects modeled after the U.S. Securities Act of 1933 and Securities Exchange Act of 1934. Under the Japanese Securities and Exchange Law all publicly held companies must file a second set of financial statements with the Ministry of Finance, which administers the law and has the power to establish accounting and auditing standards applicable to financial statements filed with it. The Ministry has an advisory body called the Business Accounting Deliberation Council, whose members are drawn from industry, the accounting profession, government and the universities, and have an accounting background, or at least a strong interest in financial reporting. Consequently, while the net income of financial statements filed with the Ministry must be the same as statements prepared in accordance with the Commercial Code, the disclosure required under the Securities and Exchange Law is much greater. 14/ Perhaps the most significant differences under the Securities and Exchange Law and the Commercial Code are the requirements of the former for supplemental consolidated financial statements and audits by independent accountants.

13/ *Id.* at 8.

14/ *Id.* at 9.

The additional requirements of the Ministry of Finance are relatively recent and quite significant. While the Commercial Code is still extant, there seems to be a shift within the government towards acceptance of the views of the Ministry of Finance and a more economic approach in financial reporting. 15/

3. Problems Posed by Differences in Accounting Standards

Differences in accounting standards present significant obstacles to international capital raising efforts. There is the cost in terms of time and money incurred by multinational enterprises in order to consolidate divergent financial information when national laws or practice differ. 16/ In addition, capital flows may be impeded by the absence of comparable, timely financial information.

With specific reference to the U.S., the question arises whether investors are being deprived of investment opportunities because the more stringent U.S. accounting, auditing and disclosure requirements act as a deterrent to capital raising efforts by foreign issuers. For example, financial reporting for segments of an enterprise is a requirement of U.S. GAAP, but not of Japanese accounting principles. With certain exceptions, a foreign private issuer is required to provide segment information in a Securities

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15/ *Id.* at 13.

16/ *Infra*, note 25.

Act filing in the U.S. 17/ Japanese issuers are reluctant to provide segment information; this appears to be one reason that some have avoided U.S. markets when selling new equity securities. In addition to their own country, those issuers have raised equity capital primarily in European markets where generally segment reporting is not required. 18/ An analysis of overseas financing by Japanese companies for the ten year period 1974 through 1983 shows the following: 19/

17/ *See* discussion in Part C, *infra*, for details of U.S. requirements for foreign issuers.

18/ *Id.*

19/ 1984 Fact Book, Tokyo Stock Exchange: 41.

OVERSEAS FINANCING BY JAPANESE COMPANIES

(In billions of Japanese Yen)

	Stock			Bonds						Total
				Non-Convertible			Convertible			
	U.S.A.	Europe	Others	U.S.A.	Europe	Others	U.S.A.	Europe	Others	
1974	-	-	1	3	54	-	6	10	-	[illegible]
1975	-	6	-	-	276	34	63	29	13	42[illegible]
1976	30	39	5	-	250	44	26	179	5	57[illegible]
1977	43	46	3	13	184	55	13	173	11	54[illegible]
1978	-	6	-	14	180	30	10	328	-	56[illegible]
1979	-	22	-	-	235	31	18	594	5	90[illegible]
1980	12	-	96	-	173	39	13	482	-	81[illegible]
1981	-	205	12	-	128	17	79	745	10	1,19[illegible]
1982	42	70	8	-	539	5	70	574	36	*1,44[illegible]
1983	-	75	-	-	1,147	-	-	1,063	-	*2,41[illegible]

Note: Amounts include offerings by overseas affiliated or subsidiary companies.
*Including bonds with stock subscription warrants (99 billion yen in 1982, 129 billion yen 1983).

(Source: Yamaichi Research Institute)

The chart indicates that Japanese issuers have avoided U.S. markets. Although it is impossible to determine whether this results from U.S. segment requirements as opposed to other factors (e.g. interest rates in the Eurobond market are lower than in the U.S. 20/), certainly segment and other U.S. requirements are a factor. Many foreign issuers, particularly the Japanese, in comment letters written in response to the Form 20-F proposal, 21/ requested that the Commission adopt modified segment reporting. (*See* discussion in Part C, *infra*). One commentator, in a comprehensive treatment of international securities laws, 22/ states:

> The principal obstacle to access by foreign issuers to U.S. capital markets in the past has been the Commission's insistence on compliance with U.S. GAAP and Regulation S-X with respect to financial statements included in 1933 Act registration statements. The new format for foreign issuers does recognize at least as a starting point what has been referred to in this Report as foreign GAAP. There has, nonetheless, been relatively little relaxation with respect to what foreign issuers find most vexatious--that is, such matters as segmental and geographic reporting which many foreign issuers claim would involve tremendous effort and expense since their books are not maintained in that fashion and which others are reluctant to disclose for competitive reasons.

20/ Bartlett Naylor, "Executive Calls U.S. Securities Laws a Hindrance in World Capital Markets," *American Banker*, (February 28, 1986): 2.

21/ Edward F. Greene and Eric D. Ram, "Two SEC Actions Significantly Affect Foreign Issuers, Legal Times (December 6, 1982) 20. (*See*, Part C, *infra*, for a discussion of Form 20-F.)

22/ Harold S. Bloomenthal, *International Capital Markets and Securities Regulation* (New York: Clark, Boardman Company, Ltd.,) v. 10, 5-28, (1982).
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Problems also arise because statutory accounting is inflexible. Detailed specificity in statutory systems compounds the problem, and accounting principles enacted into a country's laws can take years to change. The twelve countries which comprise the EEC 23/ illustrate this problem.

The EEC was established in 1957 to facilitate the flow of goods, services and capital throughout its Member States. Toward this objective, the EEC has sought to harmonize company law, including accounting requirements, within the Member States. This harmonization is achieved by means of directives which, when approved by the EEC Council of Ministers, obligates member countries to change their national legislation to comply with the provisions of the directive. The promulgation process is a long one, however, and implementation of the directives is sometimes delayed. For example, the Fourth Directive, adopted in 1978 and containing regulations regarding the form and content of annual reports, certain accounting measurement principles, the requirement for audits, and other matters, has yet to be enacted into law in Italy 24/ and was not enacted into German law until January 1,

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23/ The twelve nations that comprise the Community are Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourgh, the Netherlands, Portugal, Spain, the United Kingdom and West Germany. Spain and Portugal became members on January 1, 1986, and have not yet adopted the accounting directives.

24/ The FAR International Omnibus 1985 (Stockholm: Foreningen Auktoriserade Revisorer FAR, 1985), 462.

1986. 25/ Work on the Seventh Directive, which requires companies to present consolidated financial statements, was begun in 1976. After a number of revisions, the EEC Council adopted the directive in 1983 and required incorporation in member countries' national legislation by 1988, with presention of financial statements according to the directive to begin January 1, 1990. 26/

Thus, it is apparent that change may be a cumbersome, time-consuming process where accounting principles are incorporated into the laws of a country. This is exacerbated in the EEC where twelve countries are involved in the process of establishment and change.

C. U.S. Approach to Foreign Issuers

Despite many dissimilarities, some attributes of commonality do exist. Certain similarities are found in the majority of the twenty-four industrial countries which comprise the Organization for Economic Co-operation and Development. The following fundamental precepts are commonly found:

1. Accrual accounting, or the matching of costs and revenues is generally employed.

2. Accounting principles are used consistently from year to year, or the effects of changes in accounting principles are quantified and disclosed.

3. Under the theory of conservatism, profits are not anticipated, but losses are provided for.

25/ Frank Roberge, "Germans Launch Compaign to Soften European Directives," International Accounting Bulletin (January 1986): 5

26/ Supra, note 24.

4. Historical costs generally provide the basis for financial statements under the going concern concept, since it is assumed that assets will continue to be used in the business.

Such similarities provide the SEC with a basis to accept financial statements presented in accordance with accounting principles that are generally accepted in the issuer's home country if accompanied by a reconciliation to U.S. GAAP.

On the other hand, certain differences in the recognition and measurement principles applied to the elements of financial statements are troublesome. For example, a business combination accounted for under merger accounting in a European country may not satisfy the criteria for a pooling of interests under U.S. GAAP. If such transactions were effected some years ago, it may be impossible to reconstruct the accounting as a purchase and the company will be unable to reconcile the accounting to U.S. GAAP. Accounting for pensions by employers and hidden reserves (used primarily by European financial institutions) pose similar problems. On the disclosure side, segmentation of financial information by industry and geographic area poses problems because many countries require disaggregation of sales and revenues only (the only requirement under the EEC's Fourth Directive) and others require no breakdown. Since accounting systems are not designed to capture the information in the absence of a national requirement for such data, gathering the information for an initial registration with the SEC can be time consuming and costly. Additionally, as noted below, many companies object to

segmentation requirements for competitive reasons.

The accounting principles which are peculiar to specialized industries, such as oil and gas production, mining, forestry, rate regulated entities, and financial institutions may vary widely. Those differences, as well as those arising from linkage between financial and fiscal reporting, are usually susceptible to reconciliation to U.S. GAAP with varying degrees of difficulty.

The legislative history of the Securities Act indicates an intent to treat foreign private issuers the same as domestic issuers. 27/ Accordingly, the Commission generally has neither discriminated against nor encouraged foreign investment in the U.S., or investments in foreign securities by U.S. investors. 28/ The Commission has emphasized, however, that its rulemaking authority in this area is conditioned upon findings that the relevant rule or form is necessary for the protection of investors and in the public interest. 29/

During the SEC Major Issues Conference, held in Washington, D.C. in January 1977, the Commission indicated that the principal problems faced by foreign private issuers related to the accounting

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27/ Hearings before the Senate Committee on Banking and Currency on S. 875. 73d Cong., 1st Sess.89-90 (1933) and Hearings Before the Committee on Interstate and Foreign Commerce on H.R. 4314, 73d Cong., 1st. Sess. 12-13 (1933).

28/ Securities Act Release No. 6360 (November 20, 1981).

29/ *Id.*

and auditing requirements that must be met in order to register their securities under the Securities Act and to file appropriate reports under the Securities Exchange Act. The Commission also stated, however, that the financial information is generally the most important part of any prospectus, and indicated that the information supplied should be susceptible to comparison with that required of U.S. companies in order that investors may make informed investment decisions. Nevertheless, some accounting accommodations have been made.

In seeking comparability in financial statements, the Commission permits a foreign issuer, with certain exceptions, to prepare its financial statements in accordance with accounting principles that are generally accepted in the issuer's home country. If there are any material differences between such principles and the measurement principles of U.S. GAAP, the income statement and balance sheet must include a reconciliation of such differences to U.S. GAAP and Regulation S-X. 30/ Where a country does not have a comprehensive set of standards, or where such standards result in financial statements that are vastly different from those prepared in accordance with U.S. standards so that they are irreconcilable, the Commission requires preparation of financial statements according to U.S. GAAP. For example, until recently Japanese financial statements were sufficiently different

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30/ Rule 4-01(a)(2) [17 CFR 210.4-01] of Regulation S-X.

from U.S. financial statements, particularly because the Japanese statements usually were not consolidated, that financial statements in compliance with U.S. GAAP were required. 31/

The Commission has made other accommodations in the area of financial reporting. In November 1979, the Commission adopted Form 20-F as a combination registration and periodic reporting form for foreign private issuers filing under the Securities Exchange Act. 32/ Form 20-F requires reconciliation of material differences between the financial statements included in the filing using non-U.S. accounting principles and financial statements prepared in conformity with recognition and measurement principles under U.S. GAAP. Under the minimum requirements of

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31/ The staff has recently reconsidered this position in view of a subsequent requirement by the Ministry of Finance in Japan that public companies provide consolidated financial statements. The staff will accept financial statements of Japanese companies prepared on the basis of Japanese GAAP assuming that the consolidated statements are the primary financial statements, that they are prepared in conformity with sound principles, that complete footnotes are included, and that the disclosures and reconciliations required by the applicable forms are included. The financial statements will continue to be audited in accordance with U.S. generally accepted auditing standards.

32/ Securities Exchange Act Release No. 16,371 (November 29, 1979). Canadian issuers who have voluntarily entered the U.S. markets are treated the same as U.S. companies for registration and reporting purposes. Supra, note 28.

Section 12 of the 1934 Act requires the registration of securities of an issuer having more than 500 shareholders and $5 million in total assets (Section 12(g)), and issuers listing securities on a U.S. stock exchange (Section 12(b)).

the Form, 33/ issuers are not required to include any additional disclosures required by U.S. GAAP and the Commission's Regulation S-X.

The Commission further accommodated foreign issuers by relaxing the requirement as to the age of the financial statements included in Commission filings. In adopting Form 20-F the Commission recognized that foreign issuers needed more time than domestic issuer's to prepare their reports since they must first comply with applicable foreign regulations before preparing the report on Form 20-F. Consequently, Form 20-F must be filed within six months of a foreign issuer's year-end as compared to three months for U.S. issuers. 34/

33/ Form 20-F contains alternative items regarding the disclosures (but not recognition and measuremment principles) required as part of the financial statements included in a filing using the Form. The minimum requirements, Item 17, apply to annual reports and specified securities registered under the Securities Act. Generally, that Item addresses only the material variations that arise from the use of accounting recognition and measurement principles that differ from U.S. standards. Item 18 of the Form provides for the same reconciliation specified in Item 17, as well as all other disclosures required by U.S. GAAP and Regulation S-X. For example, disclosure of information by industry and geographic segment is required by Item 18, but not by Item 17. However, Item 1 of the Form calls for certain segmented information about sales and revenues.

Consequently, some of the financial information included in the annual report of such issuers will not be fully comparable to the information which U.S. issuers publish and with which U.S. investors are familiar.

34/ _Infra_, note 40.

In a rulemaking proceeding in November 1982, the Commission adopted an integrated disclosure system for non-Canadian, foreign private issuers which parallels to a large extent the integrated disclosure scheme adopted for domestic issuers. The new rules permit foreign private issuers meeting certain criteria to use abbreviated disclosure documents under the Securities Act for registration of newly offered securities. Certain "world class issuers" 35/ may incorporate by reference information from the Form 20-F into a Securities Act prospectus (Form F-3), and foreign issuers who have filed periodic reports with the Commission for three years may attach their Form 20-F to a Securities Act prospectus (Form F-2) instead of including certain information directly in the prospectus.

To effectuate this integration, the new rules permit the incorporation of information by reference to Form 20-F if the issuer has elected to include the additional financial information specified in optional Item 18 of Form 20-F. 36/ The new rules

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35/ A world class issuer is described as a foreign private issuer that has voting stock, held by non-affiliates, with an aggregate market value worldwide of no less that $300 million, or that is registering "investment grade debt securities." Securities Act Release No. 6437 (November 19, 1982). Investment grade debt securities are those that at least one nationally recognized statistical rating organization has rated in one of the four highest categories.

36/ Foreign issuers may amend previously filed Forms to include segment data if the data were not included with the original filing and the issuer later wishes to incorporate the Form 20-F financial statements in a Securities Act filing.

exempt from Item 18 foreign offerings of investment grade debt and certain offerings to existing shareholders. Although full segment information is not required in reports filed under the the Securities Exchange Act as discussed above, the Commission determined, with the limited exceptions noted above, to require it in Securities Act filings because of the increasing acceptance of segment information as an international disclosure practice. 37/

In connection with the adoption of the integrated disclosure system for foreign private issuers, 38/ the Commission continued the practice of allowing financial statements of foreign issuers to be less current than statements of domestic issuers. The Commission recognized that foreign issuers "... are often not required to nor do they prepare quarterly or other interim financial statements." 39/ Generally, statements of foreign issuers must be as of a date within six months of the effective date of a registration statement, except in cases where the issuer makes public more current interim information pursuant to foreign laws, stock exchange requirements or otherwise. Financial statements of domestic issues are generally required to be within 135 days

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37/ Supra, note 28. See also International Accounting Standards Committee, International Accounting Standard 14, "Reporting Financial Information by Segment," London, England (August 1981), calling for information similar to that specified in U.S. GAAP.

38/ Ibid.

39/ Securities Act Release No. 6361 (November 20, 1981).

of the effective date of the registration statement. 40/

The integration system now in place represents a significant, practical step in the process of internationalization of the world's securities markets. The system parallels the system for domestic issuers but also takes into account the different circumstances of foreign registrants, in order to accommodate foreign issuers while at the same time providing adequate protection to investors relying on the U.S. securities laws. The staff's experience in processing and reviewing the disclosure documents of foreign issuers, both registrants and those exempt by Rule 12g3-2(b), 41/ suggests that the disparity between the accounting and disclosure practices of the U.S. and many other countries is narrowing. 42/

D. Efforts Toward Harmonization

The accounting professions of the U.S. and various other countries have been involved in several projects to encourage voluntary harmonization of accounting principles. The first, and perhaps most significant of these groups, is the International Accounting Standards Committee (IASC), which was formed in 1973 by

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40/ Rules 3-12 and 3-19 of Regulation S-X provide the requirements concerning age of the financial statements in an SEC filing.

41/ The exemption permits foreign issuers not listed on an exchange or the National Association of Securities Dealers automated quotation system (except for certain "grandfathered" companies) to furnish to the Commission, for public inspection, copies of material information made public in their home countries.

42/ *Supra*, note 28.

the U.S. and eight other industrialized countries with the express purpose of articulating international accounting standards. Membership has grown to 91 organizations representing accountants from more than 66 countries.

By July 1987, the IASC had issued 26 accounting standards and had 9 other projects underway. Many IASC standards provide for alternative measurement methods in determining asset, liability, equity, revenue and expense amounts. 43/ Viewed in the light of the wide variety of acceptable accounting practices worldwide, the IASC standards, if implemented in members' countries, would result in a substantial reduction in alternative measurement and reporting standards throughout the world.

Implementation of the IASC standards, however, is a problem. The IASC has no effective means to enforce compliance with its pronouncements, but must depend on the best efforts undertaking of its member organizations to promote acceptance and compliance. 44/

43/ For example, IAS 9 allows either the expensing of research and development expenditures as a period cost or the conditional deferral of development costs with amortization over the related revenue-generating period, and IAS 12 provides for either the comprehensive or partial allocation of income tax expense. Because IASC standards have narrowed, but not completely eliminated, accounting alternatives, there are no fundamental differences between IASC standards and generally accepted accounting principles in the United States.

44/ IASC members are pledged to use their best efforts to seek general acceptance and observance of IASC standards internationally. Additionally, members must endeavor to have auditors satisfy themselves that financial statements comply with those standards, and if not, to disclose the fact of noncompliance in the financial statements or in the auditor's report.

The alternatives allowed by IASC standards generally encompass the best practices and thus should obtain substantial acceptance by the IASC constituency. To date, voluntary implementation has achieved a certain amount of success. Many of the companies listed on the Toronto Stock Exchange, for example, have been persuaded to comply with IASC standards. 45/ In Europe, listed companies in Italy (a small but important group) are required to follow IASC standards in the absence of local requirements 46/ and the listing requirements of the London Stock Exchange likewise call for compliance with IASC standards or disclosure and explanation for any deviation. 47/

Another effort at voluntary harmonization was begun in 1977 with the formation of the International Federation of Accountants (IFAC). IFAC presently has a membership of 91 accountancy bodies from 66 countries. Its purpose is the development and enhancement of a coordinated world-wide accountancy profession with harmonized standards. Like the International Accounting Standards Committee, IFAC must depend on voluntary acceptance of its guidelines. Harmonization of standards is dependent upon the undertaking of member bodies to work towards implementation of IFAC prouncements in their particular countries, when and to the extent practicable.

45/ Professor Chris Nobes, "Is the IASC Worthwile?" International Accounting Bulletin (February 1986): 14

46/ Ibid.

47/ An exception is that companies incorporated outside the U.K. are not required to comply with IAS 14 (segment reporting). See, International Securities Law and Practice (London: Euromoney Publications Limited (1985): 256)

In October 1982, IFAC and IASC entered into an agreement formalizing the relationship between the two international accountancy bodies. Under that agreement the membership of the two organizations was unified on January 1, 1984, and the IFAC was given the authority to nominate the thirteen countries represented on the IASC board. Further, the agreement recognizes the IASC as the sole body with responsibility and authority to issue pronouncements on international accounting standards and the promotion of world-wide acceptance and observance of those standards.

Both the United Nations and the Organisation for Economic Co-operation and Development 48/ have established intergovernmenta working groups on financial accounting and reporting. Those groups seek to foster harmonization and accounting and reporting standards by calling attention to the discordance which differing recognition, measurement, and reporting requirements cause in comparisons of financial information across national and regional boundaries. The working groups, like the IFAC and IASC, depend largely on persuasion and member support for effectiveness. The U.S. is a member of OECD working group, and was a member of the U.N. group but withdrew in 1986 for budgetary reasons following a cost/benefit assessment. The IASC, and a limited number of other international and regional organizations, are observers or advisor

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48/ The OECD is an organization composed of 24 industrial countries including the United States.

to the U.N. and OECD working groups.

A notable consequence of the work of the OECD and UN working groups has been the voluntary restructuring of the IASC. In response to dissatisfaction expressed by a number of countries about the dominance of founding members and the inability of others to participate in its activities, the IASC has seen changes in its structure. It has established a consultative group within the IASC 49/ and has provided for broader representation on the IASC Board. 50/

The influence of the EEC on the harmonization process has also been substantial. Although the company law directives to date

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49/ The Consultative Group (formed in 1981) is composed of representatives from the following organizations:
- Federation Internationale des Bourses de Valeurs (the International Federation of Stock Exchanges);
- International Association of Financial Executives Institutes;
- International Chamber of Commerce;
- International Confederation of Free Trade Union;
- The World Bank.
- International Banking Associations (November 1985)

In addition, representatives from the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting of the United Nations and from the Working Group on Accounting Standards of the OECD are invited participants. The Group participates in IASC Board activities related to the selection of projects to be undertaken and the review of exposure drafts prepared by steering committees.

50/ The eight founding members of the IASC will continue to control the IASC Board until 1987. After that, the recently expanded Board of 17 members will not necessarily include representatives from all the founding bodies. In addition, the Board has the power to invite up to four international

(footnote continued)

provide options from which member countries may choose in the process of incorporating directive provisions into national law, member countries are bound by the Treaties of Rome 51/ to enact directive provisions into national law. Thus, unlike the private sector and intergovernmental bodies referred to above, the EEC is able to implement its pronouncements. Nevertheless, EEC directives set forth only minimum requirements which member countries may require, for example, a statement of changes in financial position (or cash flows), or an expansion of the minimal segmentation requirements of the Fourth Directive.

E. Standard Setting - Auditing

Auditing standards have developed in much the same manner as accounting principles. Governments generally have been a major factor in setting the scope, objectives and standards of the audit, as well as requiring the independence and qualification of auditors in those countries where they have been a factor in

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__/ (footnote continued)

organizations, which are not accountancy bodies but have an interest in financial reporting, to be represented on the Board. The International Co-ordinating Committee of Financial Analysts' Association ("ICCFAA") joined the Board on January 1, 1986, as the the first non-accountancy body member. Prior to that date, ICCFAA was a member of the Consultative Group.

51/ These are treaties signed by the six original countries in Rome in 1951 establishing the EEC, the European Coal and Steel Community, an the European Atomic Energy Community.

establishing accounting principles. Statutory auditors (as opposed to independent financial auditors which may be retained separately) in those countries attest to the conformity of the company's accounts with the law and not necessarily with a true and fair view of the company's financial position and results of operations.

The objective of an audit in countries that rely on a statutory audit process often contrasts sharply with the objective in those countries where standards are set by professional organization of accountants. In the latter, the objective is the expression of an opinion on the fairness with which the financial position and results of operations are presented in conformity with GAAP.

Over the years the U.S. has taken the lead in the area of developing auditing, as well as accounting and reporting standards. These standards have had a substantial effect on international practice, both because of the head start the U.S. has had in this area and because U.S. business enterprises have played a leading role internationally in the post World War II era. 52/

52/ Belverd E. Needless, Jr. and Felix Pomeranz, "Comparative International Auditing," (International Accounting Section of the American Accounting Association): (1985) 61

Prior to the early 1930's, audits and audit reports in the U.S. were directed mainly to a company's management. As a result of the stock market crash of 1929, audits of companies offering securities to the public were mandated by the Securities Act, and annual audits of the financial statements of major investor-owned companies was required by the Securities Exchange Act. It was not until the late 1930's, however, that comprehensive audits became the norm. (Supra, note 3 at 41-15) This change was brought about by the fraud uncovered at McKesson & Robbins, Incorporated,

(footnote continued)

The AICPA's Auditing Standards Board ("ASB"), under SEC oversight, sets auditing standards in the United States. The AICPA through the ASB and other units, has adopted standards that govern the practice of auditing, including ethical standards and rules requiring that auditors remain independent of the audited client. For the most part, the SEC has permitted the public accounting profession through the AICPA, under SEC oversight, to lead the way in setting auditing standards. However, the SEC administers its own requirements regarding auditor independence. A detailed discussion of this process is contained in the "Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission before the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce", dated March 6, 1985.

F. Problems Posed by Different Approaches and SEC Response

As discussed, statutory standard setting and private sector standard setting sometimes have different objectives. Consequently auditing standards differ among nations. For example, confirmation of accounts receivable and observation of inventory are often not performed in statutory audits. Yet, these procedures are basic to

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52/ (footnote continued)

which involved, among other things, fictitious inventory and accounts receivable. As the details of the scandal began to emerge, the accounting profession, through the predecessor to the American Institute of Certified Public Accountants, initiated work on audit procedures designed to restore the public's confidence in "certificates" of independent accountants. That work resulted in a requirement that auditors observe inventory and confirm accounts receivable when either of those classes of assets represent a signifcant portion of current or total assets (see discussion in Part E, infra).

the audit process in the U.S. and other private sector standard-setting countries, and have been for some time.

Because of these different objectives, significant accomodations have not been made to foreign issuers in the area of auditing as has been the case with accounting principles. The Commission's staff has taken the position that while accounting principles can be reconciled, auditing standards cannot. In view of this position, the Commission's staff endeavors to assure that (as discussed _supra_) financial statements of foreign entities included in filings with the Commission are comparable to those of domestic issuers. Financial Statement comparability is sought either directly, through the application of consistent accounting principles, or indirectly through reconciliation of material accounting recognition and measurement differences that arise from the use of differing principles. Steps are taken to provide assurance that the examinations of financial statements by foreign auditors are as extensive and complete as those conducted by U.S. auditors. 53/ In this regard, the staff requires foreign auditors to demonstrate that:

(1) the accounting firm is professionally qualified and in good standing in the jurisdictions where its offices are located;

53/ Auditing in one of the world's leading financial centers has come under criticism recently from that country's own accounting profession. Professor Chris Nobes reports (_supra_, note 45, P. 16) that one of Japan's senior accountants has called for the MOF to require improvement in audit quality, including the introduction of peer review. This accountant expressed concern over the poor quality of audits in Japan and stated that the profession is dominated by older practitioners, many of whom do not possess the qualifications necessary to begin practice today.

(2) the firm's members and professional staff are knowledgeable with regard to:

accounting principles generally accepted in the U.S.

auditing standards generally accepted in the U.S. ("U.S. GAAS");

tse Commission's rules and other pronouncements with respect to accounting and auditor independence; and

(3) U.S. GAAS and the Commission's rules and other pronouncements concerning independence have been followed in connection with the engagement.

The staff has found that an applicant can best demonstrate knowledge of U.S. accounting and auditing standards by using an accounting firm currently practicing before the Commission as consultant or co-auditor on the initial SEC audit engagement. Such a consultant can represent to the staff that the audit was properly planned and conducted in accordance with U.S. GAAS and that all material accounting differences were identified and quantified. Further, the consultant's letter generally describes the procedures carried out and the extent to with guidance was required.

The audit burden imposed by the SEC is not as onerous as it might first appear. Many foreign auditors do meet the SEC's requirements and actively practice before the Commission. For example, there are five major Israeli firms that have met the SEC's requirements and have been the certifying accountants in a number of filings with the Commission. In addition, the large international accounting firms are available to perform U.S. GAAS audits. Some of these firms have had a significant effect on international practice by introducing U.S. audit standards in foreign countries,

since auditors in those countries must be familiar with U.S. audit standards to serve the needs of foreign subsidiaries of large multinational U.S. parents.

Notwithstanding the efforts at harmonization, and the influence and spread of U.S. auditing concepts, statutory audits continue to be the norm in many countries. Issuers that have had only statutory audits, or do not otherwise conform to U.S. standards, are not permitted to raise capital, or register for trading in the U.S., until the financial statements for the latest three years have been audited on a basis equivalent to U.S. GAAS, as required by the Securities Act.

Actual numbers are not available, but the staff is aware of only three large international issuers that have been denied access to U.S. markets within the past two years because their audits were not in compliance with U.S. GAAS. These issuers had requested waivers of the U.S. GAAS three year audit requirement prior to filing with the Commission. Of course, it is possible that some issuers did not seek waivers because they were aware of the Commission's requirement. Nevertheless, there is no evidence that U.S. auditing standards present a significant deterrent to foreign issuers. Most potential foreign registrants are aware of the U.S. requirements and can plan ahead to mitigate the problems.

G. Efforts Toward Harmonization

By July 1, 1987, the International Audit Practices Committee of IFAC had issued guidelines on (i) professional ethics, (ii) pre-qualification education and training, and (iii) twenty-four auditing guidelines (plus three exposure drafts). Although the IFAC's

auditing guidelines are impressive, they are not coordinated in the manner of the auditing standards generally accepted in the United States. However, each of the ten standards comprising generally accepted auditing standards ("GAAS") 54/ in the United States is addressed in some depth by one or more international guidelines (see, IAG Nos. 3, 4, 6, 7, 8, and 13).

IFAC's ethics guidelines include the following on independence:

> When in public practice an accountant should both be and appear to be free of any interest which might be regarded, whatever its actual

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54/ The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

(footnote continued)

effect, as being incompatible with integrity and objectivity.

Explanatory notes on independence elaborate:

> In establishing ethical requirements relating to independence, the criterion should be whether reasonable men, having knowledge of all the facts and taking into account normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between an accountant and a client poses an unacceptable threat to the accountant's independence. It is not feasible within the scope of this Guideline to deal with all such situations which may jeopardize the independence of an accountant in public

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54/ (footnote continued)

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to be preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

practice. Those responsible in each country will need to develop ethical requirements relevant to the circumstances of their country. The following are some of the matters which, in the view of the Federation, should be considered:

(i) Financial involvement, direct or indirect in a client's affairs, _e.g._, shareholdings, loans to and from clients.

(ii) Involvement by the accountant in public practice in a client's business in an executive capacity or as an employee under management control.

(iii) What other business or occupations, engaged in concurrently with public practice, could lead to a conflict of interest or are inherently incompatible or inconsistent with the practice of public accounting or are incompatible with the need to retain the appearance of independence.

(iv) Effect of family and personal relationships on independence.

(v) The circumstances in which fees received from a client constitute an unacceptably large proportion of the total income of a sole practitioner or firm of accountants in public practice.

(vi) The acceptance of assignments on a contingency fee basis.

Development of specific independence requirements, on the basis of broad philosophical guidance, is left to each country.

United States GAAS requires the confirmation of receivables and the observation of inventories. 55/ Those procedures are

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55/ Statements on Auditing Standards, AICPA, at § 331, New York (1986). _See also_ the discussion of Standard Setting-Auditing in Section III.

contained in the statements on auditing standards (of which forty-three are presently effective) which augment GAAS by specifying the acts to be performed to comply with GAAS. IAG No. 8, in discussing audit evidence, states at paragraph 14:

> Observation consists of looking at a process or procedure being performed by others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trail.

At paragraph 16, IAG No. 8 states:

> Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor normally requests confirmation of receivables by direct communication with debtors.

The principal difference between U.S. GAAS requirements and IAG No. 8 is that the IFAC guideline cites those audit procedures as examples of what an auditor may do; by contrast, they are required procedures under U.S. GAAS in appropriate circumstances. The absence of compulsion distinguishes the IFAC guidelines from U.S. GAAS. It is consistent with the Preface to International Auditing Guidelines, which states that national regulations or pronouncements govern the audit of financial statements in a particular country. 56/

The staff has recently encouraged IFAC to codify its existing auditing guidelines, and to identify and take steps, where necessary,

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56/ See Appendix A for a comparison of International Auditing Guidelines with Generally Accepted Auditing Standards in the United States.

to make those guidelines into a comprehensive set of auditing standards. The goal is to facilitate internationalization by allowing the Commission to permit compliance with IFAC standards instead of requiring compliance with U.S. GAAS. The staff understands that IFAC is working toward this goal and believes it could be accomplished in the relative near future.

A somewhat different but related matter is the question of quality control standards for accounting firms. The AICPA issued its Statement on Quality Control Standards No. 1 in November 1979. That Standard requires firms that provide professional services to have a system of quality control that conforms with professional standards. Further, the AICPA established the Division of Firms and instituted a peer review program. The Commission oversees the peer review program for members of the SEC Practice Section of that Division, and has strongly endorsed the peer review concept. The Commission has recently published for comment proposed rules (Release No. 33-6695) that would require financial statements included in filings with it to be certifed by an independent accountant which has undergone a peer review. The comment period closed in July 1987. The rules as proposed, however, would specifically exempt financial statements examined by foreign auditors because of the impracticality of imposing the requirements.

International Auditing Guideline No. 7, "Control of the Quality of Audit Work," broadly covers quality control. Although the organizational nature of the IFAC would accommodate the establishment of a peer review program, it appears that implementation could

be carried out only on a national basis in accodance with the requirements of each member country. No such mechanism currently exists in the IFAC. In future discussions with IFAC, the Commission staff will suggest that it consider the issue of peer review.

H. Approach of Other Countries to U.S. and Other Foreign Issuers

The most rapid internationalization of the capital markets has taken place in the debt markets, with a substantial amount of this activity occurring in the Eurobond markets. 57/ Equity raised by U.S. companies in the Euromarket has been signficantly less than amounts raised through debt offerings. However, equity offerings are increasing at a significant rate (*see* Chapter II).

Listing either debt or equity securities in Europe brings foreign issuers under the requirements of the EEC listing directives, 58/ the EEC accounting and auditing directives, and the various stock exchange requirements. However, neither the EEC Directives nor the stock exchanges require financial information as extensive as that required in the U.S. by either GAAP or the SEC. Reconciliation to U.K. or other GAAP is not required. And, as discussed previously, the London Stock Exchange (LSE) although it requires foreign issuers to comply with IASC standards, makes an

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57/ Securities Act Release No. 6568 (February 28, 1985).

58/ Directives of March 5, 1979, 79/279/EEC, O. J. Eur. Comm. No. L/66/21, (March 5, 1979); Directive of March 17, 1980, 80/390/EEC, O.J. Eur. Comm. No. L100/1, (April 17, 1980); and Directive of February 15, 1982, 82/121/EEC, O. J. Eur. Comm. No. L 48/26, (February 20, 1982).

exception for segment reporting.

In the final analysis, financial statements prepared in accordance with U.S. GAAP and the requirements of the SEC are accepted when included in a document for purposes of selling debt or equity in Europe either on a listed or unlisted basis. In fact the LSE listing requirements state that financial statements of U.S. companies listed on the New York or American Stock Exchanges satisfy the accounting requirements of the LSE provided such companies observe the requirements of the U.S. exchanges combined with those of the SEC. The LSE requirements further state that an audit report which conforms to auditing practice in the U.S. is acceptable.

The Unlisted Securities Market (USM) came into existence in 1980 when members of the LSE decided there should be a way for emerging companies to gain access to public capital markets (*see* Chapter III). The USM now includes approximately 340 companies with total capitalization of $5.4 billion. 59/ In the past two and a half years, eight U.S. companies have gone public in this market; others are now giving it serious consideration. 60/

The offering document used on the USM contains the same financial statements as those required for formal listing on the LSE with one significant exception--a profit forecast for the current

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59/ *N.Y. Times*, May 16, 1986, at D1, col. 1.

60/ *Id.*

year is included, accompanied by a compilation report of the independent accountants. 61/

As discussed previously, the sale or listing of securities in Japan is governed by the Securities and Exchange Law (SEL) modeled after the Securities Act and the Securities Exchange Act of the U.S. The Ministry of Finance (MOF), which has the power to establish accounting and auditing standards applicable to financial statements filed with it, administers the SEL.

Financial statements included in a registration in Japan may be prepared in accordance with U.S. GAAP. (Certain other countries accounting principles have also been accepted). 62/ Differences between U.S. GAAP and Japanese GAAP must be explained, but the differences are not required to be quantified. The financial statements must be translated into Japanese and all amounts converted into yen at a current average exchange rate.

The financial statements included in the registration statement are required in Parts I and II of the document. The financial statements submitted in Part I must be for the most recent two full

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61/ The London Stock Exchange requires a statement as to the financial and business prospects of a company, which takes the form of a profit forecast (which must be reported on by the auditors of the company) for those comapnies entering the USM. Apparently a compilation report satisfies this requirement.

62/ Supra, note 20 at 168. The Tokyo Stock Exchange, the only Japanese exchange on which foreign securities may be listed, will not accept a company for listing with a qualified audit report.

business years, the last day of which must be within eight months of the date of filing of the registration statement. If the last day is not within eight months of the filing date, then semi-annual financial statements must also be included. Part II requires financial statements for the past five years from which the statements included in Part I may be omitted. 63/

I. Accountants' Liability

1. Introduction

Professional liability is a current problem for accountants not only in this country but around the world. 64/ According to information gathered by the SEC and reported to the House Subcommittee on Securities in March 1985, over a five-year period members of the eight largest U.S. accounting firms paid in excess of $179 million in judgments and settlements of audit-related litigation. In addition, claims in pending cases in the U.S. and abroad total hundreds of millions of dollars. The April 1985 edition of the International Accounting Bulletin noted several pending cases, such as a 167 million pound claim in the U.K. against Arthur Young regarding Alexander Howden; a liquidator's writ for 100 million pounds in the U.K. against

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63/ Id.

64/ In this country, legislative proposals have been made concerning possible amendments in the tort liability system to help solve these problems. Amendments are also reportedly being considered in the U.K. and Australia.

Arthur Andersen regarding De Lorean Motors; and other cases pending in Ireland, Australia and New Zealand.

2. Accountants' Liability in the United States.

On July 2, 1985, the Commission furnished the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, with a comprehensive report on accountants' liability under the federal securities laws. 65/ This report discussed accountants' liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, and disciplinary actions under the Commission's Rules of Practice.

In addition to liability under the federal securities laws, accountants practicing in the U.S. face potential liability under state law for gross negligence or recklessness in the performance of their accounting and audit work. There is diversity among the states, however, as to which parties may bring such a negligence claim. In New York, before an accountant may be held liable in negligence to a noncontractual party who relies to its detriment

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65/ See Hearings Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, 99th Cong., 1st Sess., on Oversight of the Accounting Profession and the Securities and Exchange Commission: Effectiveness, Independence, and Regulation of Corporate Audits, February 20 and March 6, 1985, Serial No. 99-17, page 1020.

on an inaccurate financial report, a plaintiff must prove that: (1) the accountants preparing or certifying the report were aware that the financial reports were to be used for a particular purpose; (2) plaintiff would rely for this purpose on the financial report; and (3) there must have been some conduct on the part of the accountants linking them to that party, which evidences the accountant's understanding of the party's reliance. 66/ If these conditions are satisfied, then the court may find that there is a relationship resembling privity of contract between the accountant and the damaged party and permit a negligence action against the accountant. Since the privity requirement was first adopted in New York in 1931 67/, it has become the majority position among the states, and one state - Illinois - has adopted legislation codifying this requirement. Recently, however, several state courts have rejected the privity requirement and applied the traditional "foreseeable plaintiff" test in cases involving accountants' liability for negligence. 68/

66/ Credit Alliance Corporation v. Arthur Andersen & Co., 65 N.Y. 2d 536, 483 N.E.2d 110 (1985).

67/ Ultramares Corporation v. Touche, 174 N.E. 441 (1931).

68/ See, e.g., International Mortgage Company v. John P. Butler Accountancy Corporation, 177 Cal. App. 3d 806 (1986).

Foreign accounting firms auditing financial statements to be used in the sale of securities in this country are primarily concerned with liability under the federal securities laws, 69/ although the Racketeer Influenced and Corrupt Organizations Act (RICO), state and other laws may affect accountants' exposure to liability depending on the particular circumstances of each case.

3. Accountants' Liability Overseas.

U.S. accounting firms preparing or certifying financial statements used in securities offerings in foreign countries will generally be subject to the laws of those countries. Many of these

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69/ When an issuer makes a registered offering in this country, the accountant's consent regarding the use of its report is filed as an exhibit to the registration statement. The filing of this consent and the accountant's preparation or certification of the issuer's financial statements provides a basis for the accountant's exposure to liability under Section 11 of the Securities Act. Many other provisions of the federal securities laws which are broader in scope than Section 11 (and pertain to "any person" who engages in the proscribed conduct) would concern a foreign accounting firm to the same extent they would concern a U.S. firm. For example, Section 10(b) of the Securities Exchange Act and Rule 10(b) thereunder prohibit fraud by all persons in connection with the purchase and sale of securities. These provisions would apply to foreign accountants.

In addition to considering the laws of the nation where securities are to be offered, the extraterritorial application of other nations' laws must also be considered. The application of such laws may depend on where the securities being sold are likely to "come to rest," and the preparatory activities concerning the filing that occur in the country asserting its jurisdiction. *See* Chapter VII.

nations, however, have laws similar to those in the U.S. The following is summary of major provisions of the laws of countries in which significant capital is raised by U.S. companies, as those laws relate to the potential liability of accountants and their firms.

Canada

The provinces of Canada have separate securities laws. Many of these laws, however, are similar to U.S. laws. The Ontario statute, for example, has a provision similar to Section 11 of the Securities Act. In Ontario, each financial statement filed pursuant to the securities laws must include an auditor's report and the auditor must file a written consent to the use of his report. The filing of this consent triggers potential liability for the accountants with respect to any "misrepresentation" contained in his report. As in the U.S., the accountants have a "due diligence" defense provided they have conducted a reasonable investigation to provide reasonable grounds for a belief that there had been no misrepresentations. 70/ Liability under these provisions of the Ontario law is joint and several; however, a defendant is permitted to seek contribution from any person who, if sued separately, would have been liable to make the same payment. 71/ The United States Securities Act contains similar provisions in Section 11(f).

70/ Ontario Securities Act, section 126 (4).

71/ Ontario Securities Act, section 126 (8).

United Kingdom

Several pieces of legislation in the United Kingdom touch upon the regulation of the sale of securities. It is the Companies Act of 1985, however, which specifically requires a report by the auditors of the company to be included in the prospectus 72/ and the auditors' consent to the issuance of the prospectus containing their report. 73/ Once they have given their consent, the auditors may be liable for any untrue statement made by them in the report. 74/ The accountants have a defense, however, if they can prove that they were competent to give the report and had a reasonable ground to believe, and up to the time of the allotment of the shares or debentures, as the case may be, did believe that the statement was true. 75/

In addition, accountants issuing reports in the U.K. could be subject to a common law action for fraud. Recklessness on the part of the accountant is sufficient to prove scienter. 76/ However, plaintiffs must show that the fraudulent statement was addressed to them. This requirement has been deemed to be satified where the plaintiffs are subscribers for shares and those publishing the

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72/ Companies Act of 1985, section 56 and Part II of the Third Schedule to that Act.

73/ Companies Act of 1985, section 61.

74/ Id., section 68(4).

75/ Id., Section 68(5)(c).

76/ Bloomenthal, International Capital Markets and Securities Regulation, section 6.11 [3][a] (1st ed. 1986 revision). Accountancy Corporation, 177 Cal. App. 3d 806 (1986).

prospectus knew that the prospectus was likely to be relied on by market purchasers. 77/

Australia

In Australia, accountants may be held liable under the National Companies Code, as persons who authorized or caused the issuance of a prospectus, for untrue statements purported to be made by them as experts, and for any material nondisclosure for which they are responsible in their capacity as experts. 78/ Generally, however, they cannot be held responsible for the untrue statements or omissions of others. As in other countries, accountants in Australia have a defense if they can prove they were competent to make the report and that, on reasonable grounds, they believed their report to be true up until the allotment or sale of the securities. 79/

In addition to these liability provisions, the national Securities Industry Code contains general antifraud provisions. 80/ One of these sections prohibits the dissemination of information that is materially false or misleading and is likely to induce the purchase or sale of a security or to have an effect on the market price of the security. 81/ Under this section, recklessness may be

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77/ Id.

78/ National Companies Code, section 107(2).

79/ Id., section 107(7).

80/ National Securities Industry Code, sections 123-127.

81/ Id., section 125.

sufficient to prove scienter. 82/

Japan

Three statutes concerning accountants in Japan are The Securities and Exchange Law, the Law Concerning Exceptions from the Commercial Code with Regard to Auditing Stock Corporations (the "Special Audit Law"), and the Certified Public Accountants Law.

The Securities and Exchange Law covers both primary and secondary offerings of securities, and was modeled after the United States Securities Act and Securities Exchange Acts. A statutory prospectus filed under the Securities and Exchange law must contain audited financial statements and related financial information. Periodic reports must also contain audited financial statements. 83/ Under this statute, a purchaser of securities may bring an action against a certified public accountant who gave an unqualified opinion with respect to false or misleading financial statements contained in a registration statement or periodic report. 84/ Accountants, however (as in the U.S.), may have a defense if they can prove they acted with due diligence. 85/

Under the Special Audit Law, certain corporations must have their financial statements audited before they may be presented for

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82/ Supra, note 76 at section 10.06[1].

83/ Id., sections 11.06[3] and 11.09[1].

84/ The Securities and Exchange Law, Section 1, item 3; and art. 24-4.

85/ Id. at section 2, item 2.

approval at the annual meeting of shareholders. If the auditor's report contains an untrue statement of a material fact, the auditor may be liable to third parties damaged by the misstatement unless the auditor exercised reasonable care in preparing the report. 86/ If the directors of the company are found to be liable with the auditor, the liability of all defendants is joint and several. 87/

The Certified Public Accountants law governs many areas related to the qualifications and supervision of accountants, including disciplinary actions. In order to protect the public interest and investors, the Finance Minister may discipline accountants. 88/ Also, if false financial statements are filed with the Finance Minister, the Securities Bureau may take disciplinary action against the accountant, and may refuse to accept all or any part of registration statements and periodic reports containing financial statements audited by that accountant. 89/

J. SEC Initiatives in Internationalization

In February 1985, the SEC published a concept release soliciting public comment on methods of harmonizing disclosure and distribution practices for multinational offerings by non-governmental

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86/ Special Audit Law, art. 10.

87/ *Id.*, art. 11.

88/ CPA Law art. 32 section 4.

89/ CPA Law arts. 30 and 34-21, section 1; The Securities and Exchange Law art. 193-2, section 5.

issuers. 90/ (See Chapter III, supra.) To provide a framework for public comment, the Commission published two conceptual approaches designed to facilitate such offerings in the U.S., the U.K., and Canada. The two approaches are: (1) an agreement by the three countries that a prospectus accepted in an issuer's domicile which meets certain standards would be accepted for offerings in each of the participating countries ("reciprocal approach"); and (2) the development of a common prospectus which would be simultaneously filed with each country's respective securities administrators ("common prospectus approach"). The Commission requested commentators to express their views regarding which of these approaches, or alternative approaches, would be practical and consistent with investor protection. To faciliate responses, the Commission posed seventeen specific questions.

The Commission took the initiative in issuing the concept release because of the rapidly expanding international securities markets. In the release, the Commission stated that although significant accommodations have already been made in its disclosure requirements to facilitate foreign offerings in the U.S., it believes that the proposed conceptual approaches may lead to

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90/ Securities Act Release No. 6568 (February 28, 1985). The Commission also published a concept release requesting comment on other aspects of the internationalization of the securities markets. See Securities Exchange Act Release No. 21958, Request for Comments on Issues Concerning Internationalization of the World Securities Market (April 18, 1985).

increased harmonization. The release refers to a recent article 91/ that identified approximately 236 issuers that have an active international trading market in their equity securities. According to this article, a company with an active international trading market must have daily active trading outside its home market. Of the 236 issuers identified, 84 are U.S., 49 are Japanese, 17 are German, 16 are Australian, 13 are British, 12 are Canadian, 10 are Swedish, 7 are South African, 5 are Swiss, 2 are Italian, 2 are Belgian, 2 are New Zealanders and 4 are from Hong Kong. France, Denmark, Norway, Singapore and Malaysia each had one issuer identifed by the article as having an internationally traded security.

Seventy commentators responded to the issues raised by the concept release. Respondents included issuers, law firms, accounting firms, stock exchanges, broker-dealers, and regulatory agencies. Two general observations of the commentators should be highlighted. First, the reciprocal approach was the means favored by fifty out of fifty-seven commentators to facilitate multi-national offerings, at least on an evolutionary basis. Although the common prospectus approach was considered ideal by twenty-one of these commentators, they were skeptical because its implementation would be costly, subject to substantial time delays and, as a practical matter, difficult to achieve because of differences in standards, customs

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91/ See Yassukovich, "The Rise of International Equity," Euromoney, May 1984 at 63.

and procedures. Second, cost savings were generally anticipated under a multi-national offering system by twelve commentators with respect to expert fees and printing costs. Other possible areas of savings mentioned included management time, underwriting fees and distribution costs. Two commentators believed that cost savings, if any, would be insignificant. No cost savings were anticipated with respect to accounting and auditing matters. The Commission has not yet determined whether to propose rulemaking for adoption of either of these approaches.

The primary question to be addressed is whether SEC requirements act as impediments to foreign issuers in entering U.S. capital markets. As this study has shown, the most onerous requirements placed on foreign issuers are the requirements to reconcile to U.S. GAAP in both Securities Act and Securities Exchange Act filings, and to provide full segment information in Securities Act filings. The SEC's reconciliation provision is not required in any of the major financial centers discussed herein, other than in Canada. Profit and loss information by business segment is not otherwise required of foreign issuers in European markets or in Tokyo.

There is little evidence to suggest that the reconciliation requirement has provided a serious obstacle to foreign issuers entering U.S. markets. The requirement was severely criticized when

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92/ Supra, note 33.

the revisions to the Form 20-K 92/ were proposed, and in fact preparation of the information does impose an additional burden on issuers. Yet, respondents to the multinational proposal did not indicate that there would be a significant cost saving in a reciprocal offering document (which would exclude a reconciliation). In addition, foreign issuers continue to raise substantial amounts of capital in U.S. markets.

Sixteen commentators addressed the reconciliation requirement in response to the SEC's multinational proposal. The views were evenly split. Eight commentators including Merrill Lynch, the New York Stock Exchange Advisory Committee on International Capital Markets, J. P. Morgan Co., and several accounting firms envisioned the necessity for a reconciliation. Several others suggested that differences be explained but not quantified.

Among companies from the major financial centers of the world, segment profit and loss information appears to be of primary concern in the case of the Japanese. As previously discussed, capital raised by Japanese companies in the U.S. has been small in relation to the amounts raised in Europe. 93/

However, in addition to U.S. issuers, profit and loss information by segment is required of Canadian, U.K., and Italian issuers, and is a requirement of International Accounting Standards. Thus,

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93/ The Japanese MOF has recently determined to study the contents and method of disclosure for segment reporting with a goal of requiring it prospectively in financial statements beginning in 1988.

segment reporting has achieved substantial acceptance in international financial reporting. As a measure of this acceptance, underwritten foreign debt and equity offerings in the U.S. have averaged $5 billion per year since 1975 (segment reporting became a requirement of U.S. GAAP in 1977).

Segment reporting did not generate significant comment from those responding to the multinational release. There were only four commentors who addressed this matter, and they were divided. This may be indicative of the fact that profit and loss information by segment is not a significant issue in the U.K and Canada.

As noted, there is little evidence to suggest that U.S. audit requirements constitute a serious impediment to foreign issuers raising capital in U.S. markets. U.S. audit requirements were developed in many cases in response to specific audit failures, and have become imbedded not only in U.S. GAAS, but in a number of foreign audit standards as well. These standards serve to protect investors, and to provide confidence in the world's largest financial market.

Comments with respect to auditing standards were received from eight respondents in connection with the SEC's multinational release. The broadest standards were proposed by Merrill Lynch Capital Markets ("Merrill Lynch") and the New York Stock Exchange Advisory Committee on International Capital Markets. Both stated that U.S. distribution of foreign securities should require certification by independent auditors and use of auditing standards equivalent to U.S. GAAS. Several respondents suggested application of the IFAC standards as the international benchmark. Finally, one

Canadian accounting firm, Clarkson Gordon, indicated that under the multinational offering system, auditors may be required to comply with standards in effect in countries where their reports are relied upon or with common standards. Further, they opined that compliance with foreign auditing standards or the development of common international standards would be considerably less difficult than dealing with differences in accounting standards.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	United States	Canada	United Kingdom	European Economic Community
Approaches to Standard Setting	Set primarily in the private sector for both investor-owned and privately owned enterprises. As a general rule, only investor-owned entities must publish financial statements. SEC requirements are not applicable to the larger number of non-investor owned enterprises. Therefore, a single set of generally accepted accounting principles is achieve, by having changes made through the private-sector body--the FASB. Currently, the SEC's Regulation S-X specifies measurements standards for oil and gas producers only. However, the SEC has statutory authority to set accounting standards for public companies and closely oversees the activities of the FASB.	The Act under which a company is incorporated specifies the disclosure requirements (and sometime other aspects of accounting principles) with which a company must comply in preparing financial statements. The requirements of the various Federal and Provincial Acts are not identical and at times differ from the Accounting Recommendations in the CICA Handbook. Canadian companies that offer securities to the public are also subject to requirements set out in the relevant Securities Acts and in pronouncements of the Provincial Securities Administrators. The Handbook of Canadian Institute of Chartered Accountants is controlling only in those jurisdictions in which it is specifically incorporated by reference and in the case of Federally Chartered enterprises.	Accounting standards dards in the UK are established and implemented by the accounting profession within a broad framework laid down by legislation. Principally, legislation on company accounts is restricted to the Companies Acts of 1948, 1967, 1980 and 1981. The latter Act gives effect to the Fourth Directive of the European Economic Community. The ten Member States of the EEC are bound under the treaties of Rome to adopt national legislation to give effect to the Directives of the EEC. The accounting standards formulated by the Accounting Standards Committee are issued by the six principal UK accountancy bodies (England & Wales, Scotland, Ireland and three other UK bodies). In general, all limited liability entities are required to publish annual financial statements.	The Company law directives specify minimum requirements which supplement those of the Member States. Directives are required to be implemented into national law by each of the Members States within the prescribed time specified in each directive. It is not unusual for those periods to be exceeded.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	Italy	Netherlands	W. Germany
Approaches to Standard Setting	Not Available.	Statutory requirements concerning annual accounts are stipulated in the Civil Code. The law lays down general principles that are to be observed in the preparation of annual accounts. Any interested party who considers that a set of annual accounts does not conform to the stipulations of the Civil Code may apply to have them changed to a court that specializes, <u>inter alia</u>, in matters relating to annual accounts: the Companies Division of the Court of Justice in Amsterdam. A certain amount of jurisprudence is starting to be built up in this field. Delegations from the employers' organizations, the employees' organizations, and the Netherlands Institute of Chartered Accountants have together formed a "Tripartite Consultative Body" whose task is to provide a guide for practice, but it is has no legal force.	Accounting standards in Germany have always been established as provisions required by law, particularly in the "Aktiengesetz" (company law). In filing out this legal framework, fundamental accounting principles have been developed. There is no institution, however, except the courts, which can - though in single cases only - determine such principles. In decisions concerning these principles the courts consider not only business practice but also recommendations developed by the accounting profession.

Approaches to Standard Setting and Comparison of Major Accounting Principles

Approaches to Standard Setting

Switzerland

Principles of accounting are established and implemented by law. The "Code of Obligations", part of the Swiss commercial law, contains some rules on sound bookkeeping practice to be followed by all business enterprises and more detailed rules on accounting by joint stock companies. These regulations lay down a relatively small number of basic principles. This broad legislative framework permits considerable freedom in decisions on disclosure, presentation and valuation, which in turn has led to diverse and even conflicting practices. In fact, the only generally accepted accounting principle, in the Anglo-Saxon sense, is that of "prudence" or conservative estimation. However, it must be emphasized that the (comparatively few) major multinationals, which are organized as joint stock companies, have developed accounting practices, especially with respect to disclosure, which go far beyond Swiss legal requirements to align themselves with the generally accepted standards of international business.

France

The establishment of accounting standards is the responsibility of the "Counseil National de la Comptabilite", an official body of concertation on which representatives sit of:

a) those who keep accounts (accountants and bookkeepers in service of an employer,)
b) those who scrutinise accounts (auditors, the tax administration, the "Commission des Operations de Bourse", etc);
c) those who use accounts (firms, banks, statisticians, etc.);
d) and those who teach accountancy.

Thus, the "Conseil national de la Comptabilite" acts:

- at the stage when standards are prepared, before the legislative and regulatory provisions come into being;
- at the stage when such provisions are implemented, by means of interpretations and recommendations.

As for the accountancy profession, it acts:

- within the "Conseil National de la Comptabilite", in which it plays an important role,
- at the time when standards are implemented, in order to establish the rules of professional ethics in the matter.

Approaches to Standard Setting and Comparison of Major Accounting Principles

	Japan	Australia
Approaches to Standard Setting	Companies in Japan are required to follow the provisions of Commercial Law. Those companies which offer shares of stock for public subscription, such as companies listed on the securities exchange, are required to disclose their financial statements and other relevant information by way of securities reports, etc. Such requirement is stipulated in the Securities Exchange Law, which aims at protecting investors. The accounting standards which form the basis of the preparation of financial statements are published in the "Financial Accounting Standards for Business Enterprises", and other means. These standards represent those which the Business Accounting Deliberation Council, an advisory body to the Minister of Finance, recognizes to be generally fair and adequate in nature. Among the above-mentioned accounting standards, those which are considered to be relevant and necessary are legalized in the Commercial Law and the Securities Exchange Laws.	In Australia "accounting standards", as such, are established and implemented by the accounting profession. These standards may best be regarded as complementing extensive provisions in the companies legislation and in the Stock Exchange Listing Requirements which deal with disclosure in financial statements (and which, in effect, are accounting standards in their own right). Failure to comply with existing standards is regarded by some State Corporate Affairs Commissioners as "prima facie" evidence that accounts do not give a "true and fair" view.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

rincipal ccounting ifferences	United States	Canada	United Kingdom	European Economic Community
nventory Valuation	Weighted average cost, first-in-first-out, and last-in-first-out cost flow assumptions allowed.	Same as U.S.	LIFO cost flow assumption is not allowed.	Essentially the same as in the United States.
esearch and Development Costs	All such costs are expensed in the period in which incurred.	Certain development costs are capitalized and amortized.	Same as Canada.	If permitted by Member State, such amounts may be included in assets. Unless contrary to Member State requirement, capilized amounts must be amortized over a period no greater than 5 years.
egment Information	Extensive disclosures are required by Statement of Financial Accounting Standards (SFAS) No. 14 and Regulation S-K.	Requirements are roughly equivalent to those in the United States.	The Companies Act of 1981 implemented the EEC's Fourth Directive. The Act requires disclosure of sales and pretax income for each class of business, and sales (but not pre-tax income) disaggregated between markets.	Only sales are required to be "broken down by categories of activity and into geographical markets in so far as these categories and markets differ substantially from one another".

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal Accounting Differences	Italy	Netherlands	West Germany
Inventory Valuation	Essentially the same as in the U.S.	Essentially the same as the U.S. except that inventory may include interest cost incurred during manufacture. Inventories may also be valued at current value under the EEC's Fourth Directive if necessary to present a true and fair view (however only one major company - Philips N.V. - utilizes the method). The base stock method is also premitted.	Essentially the same as in the United States since adoption of the Fourth Directive.
Research and Development Costs	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circumstances.	Same as U.S.
Segment Information	Segment information not required.	Segment information not required.	Segment information not required.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal Accounting Differences	Switzerland	France	Japan
Inventory Valuation	Same as West Germany.	Essentially the same as the U.S. except that the LIFO cost flow assumption is not allowed.	Essentially the same as the U.S.
Research and Development Costs	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circumstances.
Segment Information	Segment information not required.	Segment information not required.	Sales by segment and geographic area are required.

Approaches to Standard Setting and Comparison of Major Accounting Principles

Principal Accounting Differences	Australia
Inventory Valuation	LIFO cost flow assumption is not allowed. Cost may exclude overhead, include only variable cost, or include variable and fixed overhead based on a normal level of capacity.
Research and Development Costs	Deferred and amortized in certain circumstances.
Segment Information	Segment information not required.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal Accounting Differences	United States	Canada	United Kingdom	European Economic Community
Business Combinations	Any goodwill resulting from a business combination accounted for as a purshase must be amortized over a period that is not greater than 40 years.	Same as United States. Pooling-of-interest accounting is permitted only in rare circumstances where it is not possible to identify one of the parties as the acquirer.	A current exposure draft suggests a maximum period of 20 years for the amortization of goodwill resulting from the purchase of a business. The EEC Seventh Directive permits amortization over a period longer than 5 years if it does not exceed the asset's economic life, and is disclosed together with the reasons therefore.	No specific provision. However, Article 37 of the 4th Directive provides for the inclusion of goodwill as an asset if allowed by the Member State, with amortization over a maximum of 5 years, or longer economic life where permitted by the Member State.
Oil and Gas Producers	The successful-efforts and full-cost methods of accounting are equally acceptable. If full-cost accounting is used, cost centers must be established on a country-by-country basis.	Cost center under the full-cost method of accounting may be determined on other than a country-by-country basis.	Both the full-cost method of accounting, essentially similar to the U.S. method, and the successful efforts method are acceptable in the U.K.	No specific provisions.
Foreign Currency Translation	Gains and losses on monetary assets and liabilities are recognized currently.	Translation gains and losses on long-term debt is deferred and amortized over the remaining life of the issue.	Essentially equivalent to U.S. requirement.	No specific provisions.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal Accounting Differences	Italy	Netherlands	West Germany
Business Combination	Goodwill resuting from a business combination can be either the excess of cost over fair value or book value of assets acquired, and may be carried forward indefinitely.	Principals are similar to the U.S. except that goodwill may either be written off immediately to equity or earnings, or be amortized over a period not to exceed 10 years.	Goodwill can be either the excess of cost over (i) fair value or (ii) book value of net assets acquired, and is reduced by earnings of the net assets acquired until exhausted.
Oil and gas Producers	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not know to the staff, but the industry is not significant.
Foreign Currency Translation	No specific requirements.	The concept of the functional currency contained in U.S. GAAP is implied in Netherlands GAAP. However, for practical reasons, Netherlands GAAP allows the functional currency of the most significant foreign operation to be applied to the total group. In addition exchange gains on long-term monetary items may be deferred and amortized to income over the period of the item, and exchange losses on loans may be set off against deferred gains.	No specific requirements.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal Accounting Differences	Switzerland	France	Japan
Business Combination	Same as Italy.	Same as Italy.	Goodwill resulting from a business combination is the excess of cost over the book value of the net assets acquired. Goodwill is amortized within a five year period.
Oil and Gas Producers	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not known to the staff.	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.
Foreign Currency Translation	No specific requirements.	No specific requirements.	Monetary assets and liabilities plus all assets carried at current values are translated at the closing rate, and all other items are translated at historical rates.

Principal Accounting Differences	Australia
Business Combination	Same as Italy.
Oil and Gas Produers	The "area of interest" method is the prescribed method. It represent a cross between full cost and successful efforts. It permits capitalization of all costs associated with an area of interest if there is a reasonable chance of recovery. An area of interest means an individual geological area which is considered to constitute a favorable environment for the presence of minerals.
Foreign Currency Translation	No specific requirements.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	United States	Canada	United Kingdom	European Economic Community
Leases	Finance-type leases must be capitalized in a manner equivalent to purchased property.	Essentially equivalent to U.S. requirements.	All leases are treated as operating leases--none capitalized.	No specific provisions.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Same as U.S., except that the sinking-fund method of depreciation is acceptable.	Real property is revalued periodically and depreciated on such basis. Income producing real estate usually is not depreciated.	Fixed assets are defined as "those assets which are intended for use on a continuing basis for the purposes of the undertaking's activities". Fixed assets must be valued at purchase price or production cost, if permitted by Member State, increased by value adjustments.
Specialized Industries	Certain accounting principles are peculiar to particular industries. For example, specialized practices are found in financial institutions, mining, retailing, construction, and farming.	The extent to which various practices differ between countries is not known.	Differences have not been identified. However, it is know that hidden reserves are permitted in the UK. Movements in such reserves are not disclosed.	A Fourth Directive equivalent for banks was issued during 1986. A similar draft directive for insurance companies is schedule for 1987. A contemplated draft directive for investment companies is not expected to be published before 1987 at the earliest.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	Italy	Netherlands	W. Germany
Leases	Finance-type leases need not be capitalized.	Principles are similar to those in the U.S. except that in practice leases are not capitalized to the same extent as the U.S.	Finance type leases need not be capitalized.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is normally stated at cost, but may be written up to replacement value. If depreciable assets are revalued, depreciation must be based on the revalued amount.	Property, plant and equipment is carried at depreciated historical cost.
Specialized Industries	The extent to which various practices differ between countries is not know.	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	Switzerland	France	Japan
Leases	Finance-type leases need not be capitalized.	Finance-type leases need not be capitalized.	Finance-type leases need not be capitalized.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is carried at depreciated historical cost.
Specialized Industries	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Australia

Leases	Finance-type leases need not be capitalized.
Valuation of Fixed Assets	Fixed assets may be carried at historical cost or appraised value.
Specialized Industries	The extent to which various practices differ between countries is not known.

Comparison of Audit Requirements and Specific Auditing Standards */

	United States	Canada	United Kingdom
Licensing Procedures	An applicant must pass the Uniform CPA Examination, hold a bachelor's degree, and have one to two years experience.	To became a Chartered Accountant, one must hold a degree with at least two years experience, and pass a national exam, administered by the CICA. Certified General Accountants must meet education and experience requirements specified by the provinces, pass courses or a national examination. RIAs meet requirements similar to those of a Certified General Accountant, but the examination is administered by the Society of Management Accountants of Canada.	The applicant must be a member of one of the following: a. The Institute of Chartered Accountants (either in England and Wales, or in Scotland, or in Ireland) b. The Association of Certified Accountants.
Training	At least equivalent to a bachelor's degree with study in accounting. Continuing professional education is required or recommended in most cases.	A university degree is required to become a Chartered Accountant, but not for the other accounting designations.	Three years of practical experience under a training contract during which several professional examinations must be passed.
Auditing Standards	GAAS, AICPA Statements on Auditing Standards (SAS), AICPA Interpretations of SAS, AICPA industry guides SEC Accounting Series Releases.	The Canadian Business Corporation Act; GAAS (Covered in the Canadian Institute of Chartered Accountants' Handbook)	The Auditing Practices Committee of the Consultative Committee of Accountancy Bodies; requirements of the Companies Act and auditing standards.

*/ Belverd E. Needless, Jr. and Felix Pomeranz, "Comparative International Auditing," (International Accounting Section of the American Accounting Association): (1985) 6-32

Comparison of Audit Requirements and Specific Auditing Standards

	France	Netherlands	Switzerland
Licensing Procedures	The applicant is placed on an official list after meeting these qualifications: a. 25 years of age b. good moral character c. citizenship in France or the European Economic Community d. passaged of the competency exam e. two years' experience in auditing.	After passing either a university or Netherlands Institute of Registeraccountants (NIvRA) examination, the applicant must show that he or she is: a. not bankrup b. not under court guardianship c. not under a court order preventing practice. The applicant must also produce a birth certificate and good conduct certificate.	There is no licensing requirement for auditors. Qualified auditors must pass the examination ("diplomierter Bucherexperte/expert comptable diplome").
Training	Academic diploma which qualifies one to sit for a competency examination.	There is no requirement for continuing education, but a minimum of ten days of continuing professional education every two years is recommended by NIvRA.	No special requirement for auditors. Qualified auditors must attend Auditor Schools, but not degree is required.
Auditing Standards	No mandatory standards; closely regulated by law, with recommendations made by the Guide published by the Compagnie Nationale des Commissaires aux Comptes.	No official guidelines; NIvRA publications assist the auditor's judgment and expertise; the Law Relating to Annual Accounts of Companies tells what information must be included, but not its scope.	The Swiss Handbook of Auditing with recommendations issued by the Special Committee of the Swiss Chamber.

Comparison of Audit Requirements and Specific Auditing Standards

	West Germany	Japan
Licensing Procedures	The applicant must be publicly appointed and sworn in after meeting personal and professional qualifications and following a government-regulated admission and examination procedure, which includes a heavy experience requirement (minimum of five years).	An applicant must pass three levels of examinations, show general knowledge of accounting, sufficient expertise as a junior CPA, and professional competency.
Training	A university course in business economics, economics, law, engineering, or agriculture. Experience may be substituted.	University degree
Auditing Standards	Commercial laws are the primary basis, but the Institute of Wirtschaftsprufers issues professional standards and guidelines.	No commercial Law Code. The Securities and Exchange Act requires: a. experience, ability, no special interest in the company; b. a fair, impartial attitute; c. due care; d. refusal to use or reveal confidential information; e. planning, execution, supervision; f. the extent of tests depends on internal controls; g. sufficient evidence for a reasonable opinion.

Comparison of Audit Requirements and Specific Auditing Standards

	United States	Canada	United Kingdom
Objective or Purpose of Audit	To give an opinion on the fairness with which financial statements present the financial position and results of operations of the company.	To attest to the fairness of financial statements presented by the organization's management.	To give an independent examination and opinion on financial statements, establishing compliance with statutory obligations and accordance with true and fair view.
Ethical Standards	Each state adopted a code of professional ethics under its Public Accountancy Act. Most resemble the AICPA Code of Professional Ethics, which calls for independence; objectivity; integrity; observance of general and technical standards; responsibility to colleagues; and other responsibilities and practices.	The Chartered Accountants for each province have their own codes, but the codes tend to be similar. The other two accounting bodies have their own national codes.	The Institute of Chartered Accountants in England and Wales publishes an Ethical Guide, which stresses professional independence, confidentiality, advertising limits, and limitations on fees, especially in multidisciplinary practices.
Enforcement	The Professional Ethics divisions of the American Institute of CPAs and of the individual state societies may discipline, suspend, or expel a member for violation of an ethical rule. The individual state boards control the licensing of CPAs.	In Ontario province, for example, the Professional Conduct Committee is partially responsible; the Disciplinary Committee presides over more serious breaches of ethics; and the Practice Inspection Commission ensures that practice meets the standards set in codes.	Each professional body may impose sanctions on members for violations. The Auditing Practices Committee provides a joint disciplinary committee.
Legal Liability	Liable to client for breach of contract or if report is not timely, for failure to detect fraud or error (including ordinary or gross neglience, negligence causing loss). Liable to a third party by Commercial Law for foreseeable errors and for gross negligence which caused a loss. The 1933 Statute covers ordinary and gross negligence on the issuance of an auditor's report whereas the 1934 Statute covers negligence on continuing reports. Answerable to client and third party for fraud. Also under liability associated with a fiduciary relationship	Liable under common law to third parties if should have been aware that the third party was part of a limited class that would rely on the financial statements. Liable for fraudulent financial statements.	Liable to third party if financial loss is clearly attributable to reliance on negligently prepared document, and the party preparing the document knew its purpose and knew (or should have known) that it would be relied on.

Comparison of Audit Requirements and Specific Auditing Standards

	France	Netherlands	Switzerland
Objective or Purpose of Audit	To certify that all reports and financial statements conform to existing rules and regulations and have been applied in good faith.	To ensure that balance sheets and accompanying notes present a true and fair view of the size and composition of capital and reserves; and that profit and loss statements and notes give a true and fair view of the size and composition of a company for the relevant fiscal year.	To enable auditors to give an opinion on the conformity of financial statements to legal requirements. Auditors are bound by law to pass judgment on the legality of available profit. Auditors must recommend approval or rejection of the accounts at the general meeting of the shareholders. There is no attestation to the true or fair view.
Ethical Standards	Set both by law and by the Code of Professional Ethics adopted by the Compagnie Nationale, including rules on independence, incompatible functions, advertising, use of title or firm name, relationships with colleagues, connection between predecessor and successor, and fees set by law.	The Rules of Conduct for Registeraccountants (GBR) prohibit discrediting the profession, the use of information for one's own gain, the use of information from the predecessor, as well as advertising. It requires preserving records for ten years and keeping information about a client confidential.	No general code. The Ethical Code of the Swiss Chamber, which applies to members only, requires due care, independence, secrecy, careful choice of collaborators, loyalty, teamwork, promotion of the rising generation, continuing education, responsibility for making clients' documents available on request, and respect for the Fees Convention.
Enforcement	Penalties set by law, and in some cases by the Compagnie Nationale.	Complaints received by the Disciplinary Board and the Board of Appeal, elected by NIvRA.	A Special Committee of the Swiss Chamber has the power to fine or expel members.
Legal Liability	Violation of laws which regulate the profession, subject to Penal Code; requirements stated by law; auditors required to carry liability insurance.	Criminal and civil liability for criminal offense (fines to imprisonment), for negligence, acts discrediting the profession; for violating professional rules (resulting in written warning, suspension, and expulsion).	Firms can be sued for damages.

Comparison of Audit Requirements and Specific Auditing Standards

	West Germany	Japan
Objective or Purpose of Audit	To determine that financial statements comply with German law and the company's statutes.	The Commercial Law Code does not specify the purposes of an audit; the Securities and Exchange Act specifies that it is to protect stockholders and creditors, to confirm that the financial statement fairly and appropriately shows the present position and results, and that it is prepared in conformity with A Statement of Business Principles.
Ethical Standards	A Code of Ethics covers legally required audits. Detailed guidelines issued by the Chamber of Auditors include independence, professional care, partial responsibility, discretion, impartiality, professional conduct, and elimination of incompatible duties.	The CPA Law and the JICPA Code prohibit the impairment of trust, and require independence, secrecy, and restrictions of advertising. Punishment may be administered for false and unreasonable attestation.
Enforcement	A self-regulatory body can warn, reprimand, fine or expel an auditor who is guilty of not performing duties in accordance with professional law and standard.	Under CPA law, the Minister of Finance is empowered to investigate violations and to assess penalities, including warning, suspension, or withdrawal from registration. The CPA has the right to vindi cate himself. The JICPA Punishment Committee also enforces ethical standards. The President of the JICPA determines penalities according to the views of the committee and the board.
Legal Liability	Unlimited liability to clients and third parties for false statements or other intentional violations. Liability is limited in case of negligence. Breach of confidentiality is a criminal offense.	Under the Securities and Exchange Act, if investors lose because of material errors in audited financial statements, auditor or firm must compensate for an error unless can prove lack of intention and that the attestation was made with due care. Under the Commerical Law Code, must compensate client for breach of contract, and third parties for damage from materially false items in an audit report if cannot prove due care.

	United States	Canada	United Kingdom
Responsiblity for Detection of Fraud	Within inherent limits must plan examination to search for errors and irregularities that would have a material effect on financial statements. Must form reasonable assurance through complying with GAAS that material fraud or error is not present.	Reasonable assurance through complying with GAAS that material fraud and error are not present in the financial statements. No separate other responsibilities (but management has its own responsibilities).	Obligated to pursue matters of a suspicious nature.
Concept of Independence	Must meet in fact and in appearance. Rules specified by the Code of Professional Ethics.	Defined by rules of professional conduct of the Institute of Chartered Accountants and by incorporating acts.	Discussion Doctrine on Professional Ethics focuses on compromises of independence.
Functions Generally Not Allowed	Serving as an employee of the client, holding direct or material indirect interests being an officer of client, or having a loan to or from the client, making decisions if serving as a management consultant, or performing unethical functions that impair independence.	Serving in any function that lessens, independence, taking part in decision making in a management consultant engagement; auditing a corporation where stock in the client is owned.	Being partner or member of the board of a client, or a government employee; being a shareholder, with a large part of income from one client; or providing related financial, consulting, or tax services; compromising personal relationships.
Audit Reports	Must indicate the scope of the examination and whether or not the audit complied with generally accepted accounting principles. Must state whether the financial statements present fairly in accordance with GAAP and whether GAAP have been consistently observed in relation to reports of previous years. Must express an opinion on the financial statements as a whole, or assert that an opinion cannot be expressed. Disclosures of information shall be regarded as reasonably adequate unless stated otherwise.	Must refer to the scope of the examination, and express an opinion of the financial statement or assert that an opinion cannot be stated (giving the reasons why). The opinion should indicated whether the financial statements present a fair picture in accordance with an appropriately disclosed basis of accounting which normally would be generally accepted accounting principles. The basis of accounting must be consistently applied.	Includes both scope and opinion paragraphs. By statute, must present views on balance sheets (true and fair view at their date), profit and loss statements (true and fair view), and accounts (as to whether prepared in accordance with the Companies Act). Must report "by exception" on whether proper records have been kept, whether proper and adequate returns were received from unvisited branches, whether balance sheets and profit and loss statements agree with records, and whether the auditor has received all required information.

	Frances	Netherlands	Switzerland
Responsibility for Detection of Fraud	No responsibility; but liable to client and third parties for fraud and negligence; must report known illegal acts by client.		Not bound to search for fraud; not responsible if due care is observed.
Concept of Independence	Appearance as well as fact of independence; relationships to avoid are detailed by law.	Independence from audit clients is required. Appearance of independence is emphasized.	Not defined. Independence in fact is more important than independence in appearance. Independence is not required by present Company Law (although it is by a new draft of the law, especially in regard to the board of directors and principal shareholders).
Functions Generally Not Allowed	Receiving any special benefit from a client or holding an incompatible position as a board member, a part of management, or an employee.	Drawing contracts or articles of association, acting in a managerial capacity, accepting an executive appointment in business or industry, acting as an insurance agent or broker, carrying out work affecting independence or impartiality, performing accountancy, taxation, or management consulting while employed as an auditor.	Serving as a member of the board or as an employee of the corporation, carrying out management duties. Fees from one client cannot exceed 10 percent of total income.
Audit Reports	Must certify the financial statements, or inform readers that it cannot be certified. The report may be qualified or unqualified. A second report is required, if applicable, detailing agreements entered into between company directors and the firms, or between company directors, and outside firms. There is no standard format for either report.	The wording is not specified by law, but NIvRA recommends reference to a "true and fair view" without reference to auditing standards. Under the Commercial Code, must make report available to shareholders 15 days before the annual meeting; must submit the financial statement and report to the Business Gazette within eight days of the meeting for public inspection; not required to include references to other investigations into accounts or corporate affairs; customarily, must give a more detailed report to executive and supervisors.	Presents to an ordinary shareholders' meeting the short form (attest function), containing scope and opinion paragraphs without reference to "true and fair" views. Presents the long form (with detailed audit information) to the board of directors. Presents special reports (covering extraordinary matters, such as fraud) to the board, and, in case of emergency, to an extraordinary shareholders' meet-

Comparison of Audit Requirements and Specific Auditing Standards

	West Germany	Japan
Responsibility for Detection of Fraud	Expected to conduct examination in an impartial and conscientious manner. Liabile if failure to discover fraud results from negligence.	Auditor must use due care to detect causes of material difference in financial statement; auditor may be punished by law. Must report actions that contradict directors' duties to the Auditing Commission.
Concept of Independence	Appearance as well as fact of independence. Relationships to avoid are detailed by law.	Concept of independence (fair and impartial attitude) set forth in professional standards. Specific rules set forth in CPA Law.
Functions Generally Not Allowed	Exercising management functions by acting as an employee. Independence is impaired when the auditor prepares the financial statements, has a financial interest in the client, serves on the supervisory board or board of management, or is an employee of the client.	An auditor or spouse cannot be independent if serving as an official of the corporation or responsible for financial affairs within one year of an auditing report; employed within one year of a report; holding a material interest in the corporation; connected closely, in present or past, with the corporation through duties as a government official; providing tax services or management consultant services.
Audit Reports	Prescribed by law. The recommended wording is "The accounting and the annual financial statements, which I (we) have audited in accordance with professional standards, comply with German law and the company's statues.	Must outline the work performed and state an opinion on the financial statements, expressing whether the statements fairly present the results. Must state, in addition, matters materially affecting the financial statements in subsequent periods, but not present in the current financial statement.

COMPARISON OF IFAC AUDITING GUIDELINES WITh
GENERALLY ACCEPTED AUDITING STANDARDS IN THE U.S.

U.S.GAAS*	General Content	IFAC GUIDELINE
STATEMENTS ON AUDITING STANDARDS--INTRODUCTION		
Responsibilities and Functions of the Independent Auditor	Distinguishes between responsibilities of auditor and management, and refers to professional qualifications.	IAG No. 1 contains similar language about management's responsibility for financial statements. IAG No. 3 refers briefly to auditor skills and competence.
The Relationship of Generally Accepted Auditing Standards to Quality Control Standards	Stipulates that a firm should establish quality controls and procedures to provide it with reasonable assurance of conforming with GAAS in its audit engagements.	IAG No. 7 provides guidance regarding the procedures to be followed in the delegation of work to assistants. That Guideline also covers the policies and procedures to be adopted by an audit firm to provide reasonable assurance regarding the quality of audit work generally.
THE STANDARDS OF FIELD WORK		
Relationship Between the Auditor's Appointment and Planning	Stresses the importance of early auditor appointment to proper planning and execution of audit procedures.	Not referred to in IAG No. 4, "Planning".
Planning and Supervision	Recounts the matters which an auditor should consider in planning and supervising the audit.	Planning aspects addressed in IAG No. 4. Supervision alluded to in IAG No. 7.
Audit Risk and Materiality in Conducting an Audit	Cautions auditor on audit risk and materiality when statements in accordance with GAAS.	Not addressed.
Substantive Tests Prior to the Balance-Sheet Date	Sets forth factors to be considered in applying substantive tests at an interim date and extending that work to the balance sheet date.	Not addressed.
Communications Between Predecessor and Successor	Provides guidance on communications between auditors when a change has taken place or is in process.	Not addressed.
Analytical Review Procedures	Describes the timing, objectives, and timing of analytical review procedures and investigation of significant fluctuations.	IAG No. 12 is substantially equivalent to U.S. GAAP.

The Auditor's Study and Evaluation of Internal Control	A comprehensive statement which includes definitions and basic concepts, the scope of the auditor's study and review, the timing and extent of tests, and the evaluation of the management's system of internal control.	IAG No. 6 captures the essence of subject in a relatively lengthy document which is more in a philosophical vein than a handbook approach.
The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination	Discusses the influence of the work done by the internal auditors on the planning and execution of the external auditor's procedures.	IAG No. 10 is essentially equivalent to U.S. GAAS.
Required Communication of Material Weaknesses in Internal Accounting Control	States the requirement for the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that came to the auditor's attention.	A single paragraph in IAG No. 6 states that material weaknesses should be communicated, usually in writing, to senior management on a timely basis.
Special Purpose Reports on Internal Accounting Control at Service Organizations	Audit considerations where an audit client utilizes a service organization and another auditor issues a special purpose report on certain aspects of internal accounting control of that organization.	Not addressed.
Evidential Matter	Describes the nature, competence, and sufficiency of evidential matter, as well as guidance on evaluation of evidence used to test the assertions of management.	IAG No. 8 describes considerations bearing on audit evidence. Succinct but adequate treatment.
Errors or Irregularities	Provides guidance on the auditor's responsibility for detecting errors or irregularities. It also discusses procedures that the auditor should perform when his examination indicates that material errors or irregularities may exist.	IAG No. 11 is similar to U.S. requirement.
Illegal Acts by Clients	Provides guidance when client acts which appear to be illegal come to the auditor's attention during an audit.	Not addressed.
Receivables and Inventories	States that the confirmation of receivables and observation of inventories are generally accepted auditing procedures. Provides guidelines to carry out those procedures.	IAG No. 8, Audit Evidence, in the paragraph on observation, "For example, the auditor may observe the counting of inventories...." Included in the two short paragraphs on inquiry and confirmation is, "For example, the auditor normally requests confirmation of receivables by direct communication with debtors. No other references are made to those matters.

Long-Term Investments	Furnishes guidance for audits of companies with long-term investments accounted for under the either the cost or equity methods.	Not addressed.
Client Representations	Establishes a requirement that the independent auditor obtain written representations from management as part of a GAAS audit.	IAG No. 22 states that the auditor should obtain evidence that management acknowledges its responsibility for the appropriate presentation of the financial statements and has approved them. It goes on to say, "The auditor can obtain evidence of management's acknowledgement of such responsibility and approval from relevant minutes of meetings of the management board or similar body or by obtaining a written representation from management or a signed copy of the financial statements.
Related Parties	Provides guidance on procedures that should be considered by the auditor to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.	IAG No 17 refers to International Accounting Standard 24 for definitions and required disclosures regarding related party transactions. The guidance provided is similar to that under U.S. GAAS.
Using the Work of a Specialist	Recites instances in which the auditor may find it desirable to use the work of a specialist; discusses the selection, use of findings, and the effect of the specialist's work on the auditor's report.	IAG No. 18 is at least as complete as U.S. statement.
Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	Sets forth guidance on the procedures an auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters.	Not addressed.
Working Papers	Discusses the functions and nature of working papers, as well as their content and ownership and custody.	IAG No. 9 is more demanding than U.S. requirement in that it refers to working papers "sufficiently complete and detailed for an experienced auditor to obtain an overall understanding of the audit." It also refers to permanent files included in the working papers. U.S. auditing literature does not refer to permanent files.

The Auditor's Considerations When a Question Arises About an Entity's Continued Existence	Matters to be considered by the auditor when information comes to his attention that raises a question about an entity's ability to continue in existence.	Not addressed.
Audit Sampling	Provides guidance for planning, performing, and evaluating audit samples.	IAG No. 19 provides adequate guidance in somewhat less detail than U.S. statement.
Consideration of Omitted Procedures After the Report Date	Describes considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more necessary auditing procedures were omitted.	Not addressed.
THE FIRST, SECOND, AND THIRD STANDARD OF REPORTING		
Adherence to Generally Accepted Accounting Principles	Construes the term "generally accepted accounting principles" to include not only acounting principles and practices but also the methods of applying them. It requires a qualified opinion if scope limitation makes it impossible for the auditor to form an opinion about conformity with GAAP.	Not addressed.
The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report	Explains the meaning of the phrase "present fairly...in conformity with generally accepted accounting principles" in the independent auditor's report.	Not addressed.
Consistently of Application of Generally Accepted Accounting Principles	States the objective of the second reporting standard regarding the requirement to state whether accounting principles have been consistenly applied between periods.	Partially addressed in IAG No. 13 which suggests identification of the framework of accounting principles within which he has reached his opinion, there is no reference to consistency of application.
Adequacy of Disclosure in Financial Statements	Elaborates the third standard of reporting regarding the adequancy of informative disclosures in financial statements.	Not addressed.
Segment Information	Provides guidance to an auditor in examining and reporting on financial statements that are required to include segment information in conformity with FASB Statement 14.	Not addressed.
THE FOURTH OF REPORTING		
Association With Financial Statements	The objective of the fourth standard of reporting is to prevent misinterpretation of the degree of responsibility the accountant assumes when his name is associated with financial statements. This statement defines "association" as that term is used in the fourth reporting standard.	Not addressed.

Report. .omparative Financial Statements	This statement provides guida... .o an auditor on financial statements of one or more prior periods that are presented on a comparative basis with financial statements of the current period.	Not addressed.
Reports on Audited Financial Statements	This statement distinguishes the types of report, describes the circumstances in which each type of auditor's report ate and gives examples.	IAG No. 13, "The Auditor's Report on Financial Statements", treats the same subject matter.
Dating of the Independent Auditor's Report	Covers audit reporting dating initially, for subsequent events, and upon reiss..ance.	IAG No. 13 simply states that the report should be dated.
Other Conditions Which Preclude the Application of Necessary Auditing Procedures	Calls for a qualified or disclaimed opinion when auditor is unable to satisfy himself as to opening inventories or material amounts of long-term investments.	Not addressed directly although IAG No. 8, "Audit Evidence" should be sufficient for an auditor to reach appropriate conclusion.
Part of Examination Made by Other Independent Accountant	Sets forth the matters for an auditor to consider in deciding whether he may serve as principal auditor and use the work and reports of other independent auditors who have examined the financial statements of one or more of the components or investments, and the form and content of the principal auditor's report in those circumstances.	IAG No. 5 is similar in content to U.S. statement.
Lack of Conformity with Generally Accepted Accounting Principles	States that GAAP also applies to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. An auditor's report on regulatory based principles ordinarily will contain a qualified or adverse opinion if the financial statements are to be used for other than filings with supervisory agencies.	Not addressed
Inadequate Disclosure	Calls for a qualified or adverse opinion where financial Missing information, where practicable, is to be provided in the auditor's report, unless GAAS permits omission.	Not addressed.
Reporting on Inconsistency	Provides guidance for modification of auditor's opinion where there has been a change in accounting principle.	Not addressed.
Other Information in Documents Containing Audited Financial Statements	States that the auditor's responsibility for information in a document does not extend beyond the financial information identified in his report. However, the auditor should read the other information to assure himself that it is not materially inconsistent with information in the financial statements.	IAG No. 14 is sufficiently similar to U.S. requirement

Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents	Provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client;s basic financial statements and the auditor's standard report.	Not addressed.
Reporting on Condensed Financial Statements and Selected Financial Data	Provides guidance on reporting in a client-prepared document on (a) condensed financial statements derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency, and (b) selected financial data derived from audited financial statements of either a public or a nonpublic entity and that are presented in a document that includes audited statements.	Not addressed.
Supplementary Information Required by the Financial Accounting Standards Board	Provides guidance on the nature of procedures to be applied to supplementary information required by the FASB, and describes the circumstances that would require the auditor to report concerning such information.	Inapplicable.
Supplemental Information on the Effects of Changing Prices	Expands on the guidance provided in the section on supplemental information required by the FASB.	Not addressed.
Supplementary Mineral Reserve Information	Expands on the guidance provided in the section on supplemental information required by the FASB.	Not addressed.

Supplementary Oil and Gas Reserve Information	Expands on the guidance provided in the section on supplemental information required by the FASB.	Not addressed.
Subsequent Events	Describes the effect of post-balance sheet events on financial statements and the auditor's report. It also addresses auditor consideration of transactions occurring after the balance sheet date but before completion of the field work.	IAG No. 21 is essentially equivalent to U.S. GAAS.
Subsequent Discover of Facts Existing at the Date of the Auditor's Report	Describes procedure to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.	Not addressed.
Not applicable.	Not applicable	The subject matter of IAG Nos. 2, "Engagement Letters" and 15, 16, and 20, each dealing with some aspect of data processing are addressed in various U.S. auditing statements.

*Codification of Statements on Auditing Standards, American Institute of Certified Public Accountants, New York, New York (1985).
The statements on auditing standards are organized in the Codification in a manner which conforms to the specification of generally accepted auditing standards; namely, the general standards, the standards of field work, and the standards of reporting.

COMPARISON OF IFAC AUDITING GUIDELINES WITH
GENERALLY ACCEPTED AUDITING STANDARDS IN THE U.S.

IFAC GUIDELINE	COMPARISON WITH U.S. GAAS */
No. 1--Objective and Scope of the Audit of Financial Statements	N/A
No. 2--Audit Engagement Letters	International Auditing Guideline 2 may be more demanding or conflict with generally accepted auditing standards in the United States in the following respects: This international Auditing Guideline provides guidance on the preparation of an audit engagement letter. Although the guideline does not explicitly require the auditor to send an engagement letter, the guidance is provided in a manner that presumes the use of an engagement letter. Generally accepted auditing standards in the United States do not require the auditor to send engagement letters and do not provide guidance on the preparation of such letters.
No. 3--Basic Principles Governing an Audit	International Auditing Guideline 3 may be more demanding or conflict with generally accepted auditing standards in the United States in the following respects: Paragraph .21(b) of this Guideline requires the auditor to conclude whether the financial information complies with relevant regulations and statutory requirements. Although generally accepted auditing standards in the United States do not require the auditor to form a similar conclusion, the auditor should be aware that certain governments may require the auditor to form such conclusions as a statutory obligation.
No. 4--Planning	SAS No. 22, Planning and Supervison, states that the auditor "should prepare a written audit program (or a set of written audit programs)" as part of planning his examination. SAS No. 22 does not require that the auditor prepare a written audit plan, but states, "the auditor may wish to prepare a memorandum setting forth the preliminary audit plan." International Auditing Guideline No. 4, Planning, requires the auditor to prepare both a written audit program and a written audit plan.
No. 5--Using the Work of an Other Auditor	Paragraph 9 of this IAG specifies certain matters related to using the work of an other

auditor that the principal auditor must document. Although auditors complying with generally accepted auditing standards in the U.S. generally document such matters, there is no explicit requirement to do so.

No. 6--Study and Evaluation of the Accounting System and Related Internal Controls in Connection With an Audit	No apparent conflict.
No. 7--Control of the Quality of Audit Work	No apparent conflict.
No. 8--Audit Evidence	No apparent conflict.
No. 9--Documentation	IAG 9 is more specific than U.S. GAAS as to the form and content of working papers. It requires, among other things, that working papers be "sufficiently complete and detailed for an experienced auditor to obtain an overall understanding of the audit." It also requires that "all significant matters which require the exercise of judgment, together with the auditor's conclusion thereon," be included in the working papers. Those requirements are more demanding than the standards established by SAS No. 41, Working Papers. SAS No. 41 states that working papers are the "principal record" of the work performed and the conclusions reached concerning significant matters, but allows the auditor to support his opinion and his representation as to compliance with auditing standards "by other means in addition to work papers." IAG 9 also identifies several specific items that are normally to be included in working papers which are not specifically required by SAS No. 41 or other Statements on Auditing Standards. For example, IAG 9 states that permanent files included in the working papers should be updated currently with "information of continuing importance to succeeding audits." U.S. GAAS does not discuss permanent files.
No. 10--Using the Work of an Internal Auditor	No apparent conflicts
No. 11--Fraud and Error	No apparent conflicts

No. 12--Analytical Review

No apparent conflicts.

No. 13--The Auditor's Report on Financial Statements

IAG 13 may be more demanding or conflict with generally accepted auditing standards in the U.S. in the following respects:

IAG 13 requires that an appropriate title, such as "Auditor's Report," be used to identify the auditor's report and to easily distinguish it from reports that might be issued by others. Generally accepted auditing standards in the U.S. do not require that the auditor's report be titled, even though it is customary to do so.

IAG 13 requires the auditor's report to be signed in the name of the audit firm, the personal name of the auditor, or both, as appropriate. U.S. GAAS does not address signing auditors' reports.

IAG 13 requires that the auditor's report name a specific location, which is usually the city in which the auditor maintains his office, as the auditor's address. U.S. GAAS does not require the auditor's report to include disclosure of the auditor's address.

IAG 13 would prohibit the auditor from accepting an audit engagement when a scope limitation imposed by the client in the terms of the engagement is such that the auditor believes he would need to issue a disclaimer of opinion. U.S. GAAS states that when restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements. They do not, however, prohibit the auditor from accepting the engagement.

No. 14--Other Information in Documents Containing Audit Financial Statements

No apparent conflicts.

No. 15--Auditing in an EDP Environment

No apparent conflicts.

No. 16--Computer-Assisted Audit Techniques

IAG 16 addresses a subject that is not addressed in U.S. GAAS. Nonetheless, the guideline does not include any statements that appear to conflict with precedures normally applied when computer-assisted audit techniques are used by auditors in the United States.

No. 17--Related Parties	No apparent conflicts.
No. 18--Using the Work of an Expert	No apparent conflicts.
No. 19--Auditing Sampling	No apparent conflicts.
No. 20--The Effects of EDP Environment on the Study and Evaluation of the Accounting System and Related Internal Controls	No apparent conflicts.
No. 21--Date of the Auditor's Report; Events After the Balance Sheet Date; Discovery of Facts After the Financial Statements have Been Issued	No apparent conflicts.
No. 22-Representations by Management	No apparent conflicts.

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*/ As identified by the American Institute of Certified Public Accountants, AICPA Professional Standards, at Section 8000, Commerce Clearing House New York (1986)

INTERNATIONAL AUDITING PRACTICES COMMITTEE

International Auditing Guidelines - (IAG's)

- IAG 1 Objective and Scope of the Audit of Financial Statements

  The Guideline describes the responsibility for financial statements and the overall objective and scope of the audit of financial statements of an entity by an independent auditor.

- IAG 2 Audit Engagement Letters

  The Guideline says that an auditor's engagement letter to the client is designed to document and confirm the auditor's acceptance of the appointmert, the scope of the auditor's work, and the extent of the auditor's responsibilities and the form of any reports. The guideline describes the principal contents of an engagement letter, and the appendix contains and example of a letter.

- IAG 3 Basic Principles Governing an Audit

  This Guideline describes the basic principles governing an auditor's professional responsibilities which should be exercised whenever an audit is carried out. The basic principles identified involve: integrity, objectivity and independence, confidentiality, skills and competence, work performed by others, documentation, planning, obtaining audit evidence, reviewing accounting systems and internal control, reviewing conclusions reached, and reporting. These basic principles are the cornerstone for all succeeding International Auditing Guidelines.

• IAG 4 Planning

This Guideline applies to the planning process of the audit of both financial statements and other financial information. It is framed in the context of recurring audits, identifies key elements in the planning process and provides practical examples of items which should be considered when planning an audit. Adequate audit planning helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are promptly identified and that the work is completed expeditiously. Planning also assists in proper utilization of assistants and in coordination of work done by other auditors and experts.

° IAG 5 Using the Work of an Other Auditor

This Guideline describes considerations to be made when intending to use the work of an other auditor. It applies when an independent auditor reporting on the financial statements of an entity uses the work of another independent auditor with respect to the financial statements of one or more divisions, branches, subsidiaries or associated companies included in the financial statements of the entity. For the purposes of this Guideline, offices of the principal auditor's firm in a different country, affiliated firms, correspondents, and unrelated auditors who are involved in the audit of components of the entity are considered as other auditors.

- **IAG 6** <u>Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit</u>

  Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. However, the auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has, in fact, been recorded. Internal controls normally contribute to such assurance. This Guideline describes accounting systems, elements, objective and limitations of internal control and the audit procedures for the study and evaluation of internal control.

- **IAG 7** <u>Control of the Quality of Audit Work</u>

  Controlling the quality of audit work is essential in maintaining the high standing of the profession. This Guideline distinguishes between controls on individual audits and general quality controls adopted by an audit firm. While recognizing the interrelationship of the two types of controls, the Guideline states that general quality controls "augment and facilitate" controls on individual audits but do not replace them. This Guideline deals with the controls over delegation of work to assistants on an individual audit in order to comply with the basic auditing principles, and provides practical assistance to an audit firm in controlling the general quality of their practice. The Guideline also contains an appendix with examples of procedures to assist a firm in implementing quality control policies.

• IAG 8 Audit Evidence

Audit evidence is information obtained by the auditor in arriving at the conclusions upon which an opinion on the financial information is based. This Guideline describes the nature and sources of audit evidence, sufficiency and appropriateness of audit evidence and the methods by which it is obtained by the auditor in the performance of compliance and substantive procedures.

• IAG 9 Documentation

This Guideline provides guidance on the general form and content of working papers as well as specific examples of working papers normally prepared or obtained by the auditor. It also contains a discussion of the ownership and custody of working papers.

• IAG 10 Using the Work of an Internal Auditor

When an entity has an internal audit department, management may delegate to it some of its supervisory functions, especially with respect to the review of internal control. The internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within an entity. The objective of the internal auditor is to determine whether internal controls are well designed and properly operated. Much of the work of the internal audit department may be useful to the independent auditor for the purpose of his examination of the financial information. This Guideline provides guidance as to the procedures that should be considered by the independent auditor in assessing the work of the internal auditor.

- **IAG 11** <u>Fraud and Error</u>

  This Guideline defines fraud and error, and indicates that the responsibility for the prevention of fraud and error rests with management. The auditor should plan the audit so that there is a reasonable expectation of checking material misstatements resulting from fraud and error. The Guideline also suggests procedures which should be considered when the auditor has an indication that fraud or error may exist and includes an appendix which gives examples of conditions or events which increase the risk of fraud or error.

- IAG 12 <u>Analytical Review</u>

  This Guideline provides the auditor with an understanding of the nature of analytical review procedures as well as guidance on the objectives, timing and extent of reliance to be placed on such procedures in performing an audit. It also discussed the auditor's investigation of unusual fluctuations.

- IAG 13 <u>The Auditor's Report on Financial Statements</u>

  This Guideline provides guidance to auditors on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of an entity. The Guideline includes suggested wording to express an unqualified opinion and discusses circumstances that may result in other than an unqualified opinion. An appendix to the Guideline sets forth examples of an unqualified, qualified, and adverse auditor's report and a denial of opinion.

- IAG 14 Other Information in Documents Containing Audited Financial Statements

  This Guideline defines "other information" as financial and non-financial information included in a document which contains an entity's audited financial statements together with the auditor's report thereon. An entity usually issues such a document on an annual basis which is frequently referred to as the "annual report". In certain circumstances, the auditor has a statutory obligation to report on other information and in other circumstances he has no such obligation. This Guideline deals with the auditor's consideration of other information on which he has no obligation to report and provides guidance on the actions he should undertake if a material inconsistency or material misstatment of fact is discovered.

- IAG 15 Auditing in an EDP Environment

  This Guideline provides guidance to auditors on the additional procedures necessary to comply with IAG 3, "Basic Principles Governing an Audit", when auditing in an EDP environment. The Guideline describes the skills and competence required of the auditor as well as his responsibility when he delegates such work to assistants or uses work performed by others.

- IAG 16 Computer-Assisted Audit Techniques

  This Guideline provides guidance to the auditor when using computer-assisted audit techniques (CAATs) - particularly audit software and test data. The IAG outlines instances when CAATs may be used, factors to consider in determining whether to use a CAAT and the major steps to be performed in CAAT application. In addition, the

Guideline highlights special considerations when using CAATs in a small business computer environment.

- IAG 17 <u>Related Parties</u>

  This Guideline provides guidance to auditors on the procedures to be considered in obtaining sufficient appropriate audit evidence concerning the existence of and transactions with related parties. This Guideline is premised on the definition and disclosure requirements set out in IAS 24, "Related Party Disclosures." IAG 17 provides guidance to assist auditors in determining whether management of an entity has properly disclosed related party relationships and transactions with such parties in accordance with the provisions of IAS 24.

- IAG 18 <u>Using the Work of An Expert</u>

  This Guideline provides guidance to the auditor in instances when using the work of an expert (specialist) engaged or employed by the client or auditor. The IAG outlines examples of cases when an auditor may need to use the work of an expert and provides guidance on considerations relating to the expert's skills, competence and objectivity. IAG 18 outlines considerations that should be made by the auditor for communicating with the expert and offers specific guidance on evaluating the work of an expert.

- IAG 19 <u>Audit Sampling</u>

  This Guideline identifies the factors that an auditor should consider when designing and selecting an audit sample and evaluating the

results of audit procedures. The IAG contains guidance that applies to both statistical and non-statistical sampling methods. The Guideline provides fundamental yet practical guidance on such matters as sampling risk, stratification, selection methods and projection of errors.

• IAG 20 <u>The Effects of an EDP Environment on the Study and Evaluation of the Accounting System and Related Internal Controls</u>

This Guideline provides guidance to the auditor on the study and evaluation of the accounting system and related internal controls in an EDP environment. The Guideline is an extension of the guidance contained in IAG 6, "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit" and IAG 15, "Auditing in an EDP Environment".

The Guideline describes the common characteristics of an EDP environment, including the factors that affect the organization and structure, nature of processing and design and procedural aspects of the system of accounting and internal control.

The IAG differentiates and explains the interrelationship of general EDP controls (those that affect the EDP environment) and EDP application controls (those that affect accounting applications). The Guideline explains to the auditor operating in an EDP environment, the steps involved in a) making a review and preliminary evaluation, b) performing compliance procedures, and c) making a final evaluation, of the accounting system and related internal controls. The IAG reminds the auditor to communicate to client management weaknesses in EDP internal control and weaknesses that affect the safeguarding of data and continuity of processing.

• IAG 21 Date of the Auditor's Report; Events After the Balance Sheet Date; Discovery of Facts After the Financial Statements Have Been Issued

This Guideline provides guidance on dating of the auditor's report; the auditor's responsibility in relation to subsequent events, which are significant events occuring after the balance sheet date, and the auditor's responsibility in connection with the discovery of facts after the financial statements have been issued. This Guideline describes steps the auditor generally performs to identify subsequent events, responsibilities in relation to events after the date of the auditor's report but before the financial statements are issued, and discovery of facts after the financial statements are issued. An appendix to the guideline sets forth an example of an auditor's report on revised financial statements.

• IAG 22 Representations By Management

This Guideline provides guidance to the auditor on using management representations as audit evidence, procedures the auditor should apply in evaluating and documenting them, and circumstances in which written representations should be obtained. The Guideline indicates that with regard to representations for material financial statement matters, the auditor should seek corroborative evidence, evaluate the representations for reasonableness and consistency with other audit evidence and other representations, and consider whether the individual making the representation can be expected to be well-informed. The Guideline notes that representations can be documented in the working papers by summarizing oral discussions or by obtaining written representation. The Guideline also notes the conditions for obtaining letter from management and considerations of the auditor

when management refuses to provide or confirm representations on matters considered necessary.

- IAG 23 Going Concern

  This Guideline provides guidance to auditors in discharging their responsibilities in situations in which the appropriateness of the going concern assumption as a basis for the preparation of financial statements is in question. The Guideline notes that an entity's continuance as a going concern is assumed in the absence of information to the contrary. If this assumption is unjustified, an entity may not be able to realize its assets at the recorded amounts and there may be changes in the amount and dates of maturity of liabilities resulting in the need for financial statements to be adjusted. IAG 23 provides examples of indications that continuance as a going concern should be questioned, outlines the standard for collecting audit evidence when such a question arises, and describes the audit procedures that may be performed to obtain such evidence. In addition, it sets out the auditor's reporting considerations in such circumstances.

- IAG 24 Special Purpose Audit Reports

  This Guideline provides guidance to auditors that issue audit reports that are other than those covered by IAG 13, notably

  - Financial statements prepared in accordance with a comprehensive basis of accounting other than international accounting standards or relevant national standards.
  - Specific accounts, elements of accounts, or items of a financial

statements.

- Compliance with contractual agreements.
- Summarized financial statements.

The appendices to the proposed IAG contain illustrations of special purpose audit reports.

Exposure Draft - (ED's)

- ED 25 Materiality and Audit Risk

This proposed Guideline defines and describes the concepts of materiality and audit risk, their interrelationship and application to planning and executing an audit and evaluating audit procedures. In the exposure draft, materiality is defined as the magnitude or nature of an omission or misstatement of financial information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that, as a result of the misstatement the judgment of a reasonable person relying on the information would have been influenced, or his decision affected. It is noted in the proposed Guideline that the assessment of materiality is a matter of professional judgment that is influenced by an auditor's perception of the needs of a reasonable person who will rely on the financial information. The audit is planned and executed in order to have a reasonable expectation of detecting material misstatements. Audit risk is defined as the risk that an auditor may give an inappropriate opinion on financial information. Audit risk is considered at the financial statement level and the account balance and class of transactions level. ED 25 describes and illustrates the interrela-

tionship between materiality and the level of audit risk, and states that they should be considered together when determining the nature, timing and extent of auditing procedures and evaluating the results of those procedures. The proposed Guideline states that the audit should be planned so that audit risk is kept at an acceptably low level. It also states that the auditor's preliminary judgment of materiality should be related to specific account balances and classes of transaction enabling the auditor to decide such questions as what items, if any, to examine one hundred percent and whether to use sampling or analytical review techniques. The Guideline contains two appendices, one providing an illustration of the interrelationship of the components of audit risk and the other giving examples of rules-of-thumb that can be used to measure materiality.
(Comment period ending November 30, 1986.)

° ED 26 Audit of Accounting Estimates

This proposed Guideline provides guidance to auditors on the procedures that should be performed in order to obtain reasonable assurance as to the appropriateness of accounting estimates contained in financial information. The Guideline recognizes that accounting estimates are an important element of financial reporting and are often dependent upon management judgment and thus are subject to bias. The ED describes the nature of accounting estimates and provides examples of simple and complex estimates encountered in an audit. The Guideline describes five main steps involved in an audit of accounting estimates as follows:

- examination of the data and assumption on which the estimate is

based,

- examination of calculations involved in the estimate,
- comparison of previous estimates with actual results,
- examination of management's approval procedures, and
- assessment of the results of the audit procedures.

Because of the imprecision of accounting estimates, evaluating errors can often be more difficult than in other areas of the audit. Thus the proposed Guideline on materiality and audit risk provides good background for applying the principles contained in the audit of accounting estimates guideline.
(Comment period ending November 30, 1986.)

- ED 27 Basic Principles Governing Limited Assurance Engagements

ED-27 is the first of the IAPC's proposed pronouncements on limited assurance services and establishes the basic principles for such engagements. ED-27 is a parallel document to IAG 3, Basic Principles Governing an Audit, setting out the basic principles and general and reporting guidelines for limited assurance engagements. ED-27 notes that in an audit engagement the auditor will use more extensive audit procedures than in a limited assurance engagement because his objective is to express a high but not absolute level of assurance on the reliability of the financial information.

The proposed guideline notes that in order to perform a limited assurance engagement the auditor should:

- Possess or obtain a knowledge of accounting principles and practices of the industry in which the entity operates,

- Possess or obtain an understanding of the entity's business and procedures,
- Carry out inquiry and analytical procedures, and
- Carry out additional or more extensive procedures when deemed necessary to achieve limited assurance based on the results of the inquiry and analytical review when there is a suspicion that the information on which the auditor is reporting is not presented fairly in accordance with the basis of accounting indicated or is otherwise incomplete or unsatisfactory.

(Comment period ending March 31, 1987.)

° ED <u>Proposed Framework of International Auditing Guidelines</u>

The proposed Framework of International Auditing Guidelines:

- describes certain services that may be performed by auditors and the levels of assurance resulting from the work performed,
- provides a general framework for such services performed by auditors,
- describes the conditions for changing the scope of an engagement, and
- describes the concept of auditor association with financial information.

The proposed Framework of International Auditing Guidelines describes four types of engagement which may be undertaken by an auditor: audit, review, agreed-upon procedures, and compilation, categorized according to the level of assurance expressed by the auditor. These engagements result in three levels of assurance being expressed: high (audit assurance), moderate (limited assurance), and no assurance, such terms being used to indicate their comparative ranking. The proposed framework notes that high assurance does not indicate absolute assurance. Absolute assurance in auditing is not attainable as a result of such factors as the need for

judgment, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

The principal objective of the proposed framework is to put into perspective future pronouncements of IAPC dealing with limited assurance services and no assurance services. The proposed framework notes that in the future International Auditing Guidelines will fall into three categories:

° International Auditing Guideline Series (there have been 24 Guidelines issued in this series so far)

° International Auditing Guideline/Limited Assurance Engagements Series

° International Auditing Guideline/No Assurance Engagement Series

(Comment period ending March 31, 1987.)

CHAPTER V

International Trading and Global Securities Markets

Prepared by the Division of Market Regulation

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CHAPTER V

INTERNATIONAL TRADING AND GLOBAL SECURITIES MARKETS

A. Introduction

This chapter discusses the internationalization of secondary securities markets 1/ from several perspectives. It begins with an overview of some of the major segments of these markets: the Eurobond markets, the leading example of an integrated multinational secondary market; international equity markets, and particularly the developing foreign securities markets in London; and the international operations of multinational securities firms. The chapter then describes the staff's policy concerning two major areas of regulatory concern, broker-dealer registration and financial responsibility.

The Commission and its staff, through the Global Trading Release, 2/ the work on this study, and the February 17, 1987, Internationalization Roundtable, 3/ have monitored developments in the international secondary markets. To date, this process indicates that the markets are evolving trading and information gathering mechanisms that, in general, are safe and efficient. There is, however, a demand for improvements in international

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1/ The term "secondary securities markets" generally refers to the markets for trading securities after their initial issuance.

2/ Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302. A summary of the comments on this release is attached as Appendix A.

3/ A summary of the Roundtable is attached as Appendix B.

clearance and settlement mechanisms. Accordingly, the staff has adopted a regulatory approach that facilitates industry solutions while ensuring the essential soundness and integrity of the U.S. national clearance and settlement system. The international clearance and settlement linkages established by the self-regulatory organizations ("SROs") and approved by the Commission are described in this part.

The SROs and the Commission also have devoted substantial efforts to facilitate the development of trading linkages. In this connection, the Commission has indicated that effective intermarket surveillance is essential to the integrity of internationalized secondary markets. 4/ The Commission has approved several linkage agreements that provide for such surveillance and enforcement cooperation. These agreements are described in this part of the study. 5/ Finally, this chapter describes the way in which Rules 10b-6 and 10b-7 under the Securities Exchange Act 6/ affect secondary market trading activity during international offerings.

4/ See, e.g., Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

5/ The Roundtable participants agreed that the Commission should continue to direct its principal focus to clearing and settlement and surveillance sharing agreements. See Summary, Appendix B.

6/ 17 C.F.R. 240.10b-6 and -7.

B. Barriers to Entry and the National Treatment Study

Because the recent National Treatment Study, prepared by the Treasury Department with the assistance of the Commission, covers the issue of barriers to entry of U.S. securities firms in different foreign markets comprehensively, this topic is not discussed separately in this study. The Treasury Study concluded that the major markets studied usually seek to accord national treatment to U.S. securities firms. Since the date of the Study, France has substantially liberalized entry of foreign firms into its markets. 7/ In addition, the Tokyo Stock Exchange is reviewing the possibility of increasing the number of seats allocated to foreign firms by May 1988. The Japanese government also is expected to grant licenses to several United Kingdom and foreign banks to conduct investment management activities in Japan. 8/

Some barriers remain, however, including restrictions on U.S. firms' access to foreign exchanges. Moreover, certain restrictions that apply equally to foreign and domestic firms

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7/ See, e.g., "France Proposes a Liberalization of Stock Market," Wall Street Journal, March 11, 1987, p.41; "Foreigners Will be Able to Own French Brokers," New York Times, March 11, 1987, p.D1.

8/ See "Japanese Likely to Grant Investment Licenses Soon," Financial Times, May 23, 1987, p.1, and "Tokyo Exchange Expects to Study Foreigners' Role," Wall Street Journal, May 19, 1987, p.46.

may uniquely disadvantage U.S. firms, such as restrictions on the development of new products. 9/ In addition, one new concern in this area arose when the Japanese Ministry of Finance ("MOF") determined to permit Japanese institutions to trade financial futures, but not options. The Commission has written the MOF suggesting that there is no regulatory or economic reason for this disparity of treatment. 10/ The MOF responded by indicating that they traditionally have distinguished futures from securities options and "could not include standardized options in the liberalization" at this time without further study. 11/

C. Eurobond Trading and Settlement

The term "international markets" encompasses two different types of markets: (1) the foreign securities segments of various national securities markets, *i.e.*, the offering and

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9/ *See Department of Treasury National Treatment Study*, pp.4-5 (1986). Since this study there have been several legislative proposals in this area, including: (1) H.R. 3 and S. 1409, which, in pertinent parts (Sections 428 and 602, respectively) would prohibit a foreign firm from becoming a primary U.S. government securities dealer if the firm's home country does not accord U.S. firms equivalent competitive opportunities in the foreign country's government securities markets; and (2) S. 1420, which, in pertinent part (Section 1503) would allow the SEC, with the President's prior approval, to deny broker-dealer registration to any foreign firm whose home country does not accord to U.S. brokers and dealers "the same competitive opportunities as it accords to their domestic counterpart."

10/ *See* letter from John Shad, Chairman, SEC, to Makato Utsumi, Director-General, International Finance Bureau, MOF, dated April 30, 1987.

11/ *See* Letter from Makato Utsumi, Director-General, International Finance Bureau, MOF, to John Shad, Chairman, SEC, dated May 26, 1987.

trading of a security of an issuer of one country in the market of another country; and (2) integrated multinational markets. 12/ While the first markets are multinational in the sense that a particular security may trade in more than one country, trading occurs in discrete national markets linked only by whatever arbitrage may be possible. In integrated multinational markets, offering and trading occurs in one formally linked market setting. 13/ This section of the report describes the secondary Eurobond markets, 14/ a principal example of integrated

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12/ 1 International Finance Handbook (Wiley-Interscience, 1983), § 1.1, pp.1-7; § 5.1, p.3.

13/ Integration as used in this chapter means either: (1) trading occurs under one set of uniform procedures and under the umbrella of one SRO; or (2) traders are linked via formal data communications facilities. Eurobond markets are partially integrated in the former sense but not yet in the latter. Other multinational markets (*e.g.*, the U.S./Canadian equity markets links) are integrated in the latter sense but not the former.

14/ While the Eurobond market sometimes is referred to as one market, dealers view each bond type -- *e.g.*, floating-rate or fixed-rate U.S. dollar bonds -- as a separate market, and these separate markets evidence different liquidity. An illustration of such differences is provided by the perpetual floating-rate note market. Perpetual floating-rate notes are debt securities without a maturity date used by many commercial banks in Europe to raise permanent capital. Because these securities have no maturity date, their value is dependent to a large degree upon the presence of liquid secondary markets where holders can sell. In December 1986, due to decreasing fixed interest rates, the secondary markets for these floating-rate securities experienced severe disruptions and dealers in large part withdrew from these markets. *See*, *e.g.*, "FRN Traders Struggle to Restore Stability," *Financial Times*, December 4, 1986, p.24. More recently, the slowdown of the fixed-rate Eurodollar bond offering market has led to decreased secondary market liquidity. The Euroyen bond on the other hand has experienced increased liquidity as the value of the yen has increased.

multinational secondary markets. The settlement mechanisms for these transactions in this market also are described.

1. Eurobond Trading

Secondary Eurobond markets are the major integrated multinational securities markets. In 1986, dollar volume in this market was over $2.6 trillion. 15/ Trading is centered in London, where over 75% of this turnover occurs. 16/ Trades are executed over-the-counter ("OTC"), *i.e.*, over the telephone, among a network of members of the Association of International Bond Dealers ("AIBD"). 17/

The AIBD, a voluntary SRO established in 1969, provides uniform rules for clearance, settlement and confirmation of

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15/ *See supra* Chapter II.

16/ While secondary Eurobond markets for the most part are institutional markets, smaller individual customers increasingly are participating (primarily through Swiss banks). Of course, many U.S. broker-dealers participate in the Eurobond market, principally through their overseas (largely London) affiliates. Generally, if U.S. customers seek to trade in Eurobonds, their orders are sent to these foreign affiliates for execution overseas. Nonetheless, trading in Eurobonds does occur in the U.S. although other international bonds trade more actively, particularly Yankee bonds (*i.e.*, SEC-registered, dollar-denominated bonds of non-U.S. issuers).

17/ Some Eurobonds are listed on exchanges for technical reasons, principally because some European institutions may own only listed securities. In addition, West Germany requires Deutschemark bonds to be listed on a West German exchange. Very little trading occurs on the exchanges where the bonds are listed. Most of the listings are on the Luxembourg Exchange and the International (formerly London) Stock Exchange of the United Kingdom and the Republic of Ireland ("ISE"). *International Finance Handbook*, *supra* note 12, § 5.1, p.7.

trades. 18/ The AIBD, however, did not regulate trading until last year. In effect, each market sector, *e.g.*, fixed-rate U.S. dollar bonds, Deutschemark bonds or floating-rate notes, developed its own practices and trading customs. 19/ In 1986, the Council of AIBD Reporting Dealers 20/ was formed with the goal of establishing several important trading and reporting obligations for AIBD dealers. Currently, there are 130 dealers registered as "reporting dealers" with the Council. 21/ Unlike other AIBD members, reporting dealers register with the Council

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18/ Indeed, the AIBD orginally was formed to deal with the back office problems that virtually shut down secondary Eurobond trading in the late 1960s when primary market volume surged. *See infra* Section C.2.

19/ All dealers reported prices of Eurobonds in which they made markets to the AIBD weekly; the AIBD published the prices in the *Weekly Guide to Eurobond Prices*.

20/ The Council, whose members are AIBD members, is a separate subgroup of that organization, which enjoys a greater measure of autonomy than other AIBD committees. Telephone conversation between Alden S. Adkins, Branch Chief, Division of Market Regulation, and James Beecham, Chairman, Council of AIBD Reporting Dealers, January 30, 1987.

21/ These 130 dealers constitute the members of the Council. There are over 850 AIBD members in over 39 countries, including affiliates of the largest U.S. broker-dealers and banks. In addition to the new AIBD rules governing secondary market trades in Eurobonds, the International Primary Market Association ("IPMA"), a Eurobond underwriters group, has recommended that lead and co-lead underwriters of any fixed-rate Eurodollar bonds commit to make markets in the bonds for up to one year after the offering. *See* "Eurobond Group Sets Date on Market-making Rule," *Wall Street Journal*, June 2, 1987, p.51, and "Eurobond Group Asks Managers to Make Market in New Issues . . .", *Wall Street Journal*, June 15, 1987, p.40.

as dealers in specified Eurobonds and make two-sided quotations in a representative number of securities, a list of which is published weekly by the secretariat of the Council. More specifically, reporting dealers must undertake to make a two-way price to other members listed in the same securities at reasonable times, 22/ in minimum round lots, 23/ and in a "representative" number of securities. 24/

Each reporting dealer must communicate to the Council each Friday at the close of business the securities in which

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22/ Reporting dealers for fixed-rate U.S. dollar issues must be available from 8:30 a.m. to 12:00 noon and 2:00 p.m. to 4:30 p.m.; reporting dealers for floating-rate note issues must be available from 9:00 a.m. to 12:00 noon and 1:30 p.m. to 4:30 p.m.; reporting dealers for Eurosterling issues must be available from 8:30 a.m. to 12:00 noon and from 1:30 p.m. to 4:30 p.m.; reporting dealers for European Currency Units ("ECUs") and composite currency issues must be available from 8:00 a.m. to 12:00 noon and 1:30 p.m. to 3:30 p.m.; finally, reporting dealers for Euroyen issues must be available from 9:00 a.m. to 12:00 noon and 2:00 p.m. to 4:00 p.m. *See* Rule III(6) of the Rules of the Council of Reporting Dealers, May 1987. The Council has not established trading hours for other Eurobonds.

23/ Round lots for fixed-rate U.S. dollar issues are set between \$100,000 and \$500,000 nominal value (\$100,000 for inactive and older issues); the agreed trading size for floating-rate note issues is one million (price is negotiable below one million); for Eurosterling issues, round lots are set between \$100,000 and \$500,000; round lots for ECU issues are set between \$100,000 and \$500,000 for active issues (*i.e.*, outstanding amount is at least ECU 50 million and there must be at least 4 reporting dealers in the issue), and between \$100,000 and \$250,000 for older and inactive issues; round lots for Euroyen issues are set between yen 50 million and yen 100 million. *Id.* Rule III(5). The Council has not yet established minimum lot requirements for other Eurobonds.

24/ The Council's rules do not specify what constitutes a representative number.

it will make two-way quotations to other reporting dealers the next week. 25/ If a particular security is withdrawn from the previously disclosed list during the course of a week, the reporting dealer must notify the secretariat. The rules differ, however, for reporting dealers in floating-rate notes, Euro-Sterling issues, ECU and composite currency as well as Euroyen issues. 26/ If a dealer fails to provide two-sided quotations in securities on its list during the following week without prior notice to the Council, it can be deregistered, *i.e.*, it would be removed from the weekly list of reporting dealers, and, therefore, its quotations would no longer be published as quotations of an AIBD reporting dealer. Each reporting dealer also must report its daily closing quotations to the Council,

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25/ Different procedures apply for the last week of each calendar year. *Id.* Rule III(1)(c).

26/ Reporting dealers in floating-rate notes and Eurosterling issues may withdraw securities from the previously disclosed list after the close of each trading session and must notify the secretariat of such withdrawal. Reporting dealers in ECU and composite currencies must continue to make two-sided quotations for five working days after notification of withdrawal to the secretariat, or for one week after omitting such securities from the weekly list, whichever is the longest. Reporting dealers in Euroyen issues must give one business day's notice when withdrawing securities from the previously disclosed list. A notice of withdrawal must be sent to the secretariat as well as to all other reporting dealers making two-way quotations in the same securities.

and its daily high and low prices. 27/ The AIBD will publish these quotations and prices the following day. 28/

The AIBD rules also provide for the registration or "listing" of inter-dealer brokers, of which there are currently six. These inter-dealer brokers are required to effect transactions exclusively between reporting dealers and are not allowed to effect business with other entities (*e.g.*, retail customers). 29/ While currently inter-dealer brokers operate over the phone, two firms recently announced an intent to establish blind inter-dealer brokering screens for Eurobonds similar to those used in U.S. government securities markets. 30/

27/ The Council reports that, as of the end of June 1987, about 110 of the 130 reporting dealers were complying with these requirements, while others were slower in establishing the data communications systems necessary to fulfill the reporting requirements. Telephone conversation, *supra* note 20.

28/ Eurobond prices also are collected from dealers and disseminated by vendors such as Telerate and Reuters. Reuters collects data from approximately 340 different Eurobond dealers located in different countries covering the full spectrum of Eurobonds (*i.e.*, all currencies, fixed-and floating-rates). These dealers submit quotations directly to Reuters, and are encouraged to keep the quotations as current as possible.

29/ This restriction arises from dealers' concern that inter-dealer brokers would compete with dealers by effecting trades with customers. "The City Revolution, Pragmatic Approach to City Rules," *Financial Times*, October 27, 1986, p.26. It should be emphasized, however, that these rules are the rules of the reporting dealers, and the inter-dealer brokers have not yet agreed to them.

30/ "Eurobond Broker is Planned," *New York Times*, February 19, 1987, p.D17. The two firms have recently applied for AIBD membership; however, they have not yet applied for registration as inter-dealer brokers.

The Council and the AIBD itself are considering registration under the new Financial Services Act 31/ as a Designated Investment Exchange ("DIE") as an alternative to registering as a Recognized Investment Exchange ("RIE"). 32/ Discussions are still underway between the AIBD and the SIB; prior to registering as a DIE, the AIBD probably will have to make some adjustments. A significant requirement will be the reporting of trades by United Kingdom members. Such reporting could be made through the newly proposed "TRAX" system. The TRAX system recently was proposed at the AIBD meeting in Oslo primarily to deal with the number of failed trades, which are estimated to be between 10% and 15% of all Eurobond trades. 33/ The system will require

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31/ The "Financial Services Act 1986" was enacted (received Royal Assent) on November 7, 1986. While the AIBD functions in part as an SRO in the generic sense of the term, the AIBD does not intend to seek registration as an SRO under the Financial Services Act. AIBD dealers operating in London, therefore, will have either to join some registered SRO or register directly with the newly established Securities and Investments Board ("SIB"). As a result, they will be subject to certain requirements concerning sales practices and financial responsibility rules.

32/ The Financial Services Act requires that trades not effected on either an RIE or DIE be reported directly to the SIB, the newly authorized securities market regulatory authority in the United Kingdom. The chief difference between an RIE and DIE is that an RIE is subject to closer SIB scrutiny of its rules and surveillance processes. See generally Sir Kenneth Berrill, The London Regulatory Scheme, Securities Industry Association ("SIA"), International Capital Markets Review, October 20, 1986.

33/ See "Britain's Bid to Regulate Eurobonds Still Has Dealers Wary Outside U.K.," Wall Street Journal, May 26, 1987, p.52.

dealers to report trades within 30 minutes of execution. The trades will be matched later by the AIBD, but will not be publicly disseminated. "TRAX" will not be ready for operation before the Fall of 1988. 34/

The AIBD had considered the possibility of implementing a screen-based quotation dissemination and display system for Eurobonds similar to the National Association of Securities Dealers, Inc., Automated Quotation System ("NASDAQ"). Many of the largest houses rejected such a possibility because their trading practices are incompatible with such a system; the AIBD instead determined to proceed at this time with the TRAX system as a less drastic change to their traditional method of dealing. 35/

2. Eurobond Settlement: Euroclear and Cedel

Growth in the Eurobond market in the late 1960s created pressure for the establishment of centralized automated clearance and settlement mechanisms. At that time, the Eurobond market experienced problems similar to those that plagued U.S. equity markets: cumbersome physical settlement practices, late or failed deliveries, risk of physical loss of securities and resulting back office failures. 36/ Thus, to fill the need for

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34/ Telephone conversation with James Beecham, June 8, 1987.

35/ Telephone conversation between Victoria Berberi, Attorney, Division of Market Regulation, and Jon Wolters, Secretary General of the AIBD, June 10, 1987. See also "Screens and Roundabouts," The Economist, May 16, 1987, p.66; and "Eurobond Dealers Reject Plan for Screen-Based Quotations," Financial Times, May 13, 1987, p.1.

36/ Apparently, the need to deliver securities certificates in cross-border settlements on a trade-by-trade basis, high-volume trading in those securities, and the prevalence of bearer-form securities contributed to settlement delays and financial losses.

automated clearance and settlement facilities, Eurobond market participants formed the Euroclear System ("Euroclear") and the Centrale de Livraison de Valeurs Mobilieres ("Cedel") -- the first truly multinational clearance and settlement systems.

Euroclear was formed in 1968 in Brussels by Morgan Guaranty Trust Company under Belgian law. In 1972, ownership was transferred to 120 banks and securities firms, none of which may own over 4% of the issued stock. 37/ Euroclear is subject to regulation by the Belgian Banking Commission. Belgian law governs Morgan Guaranty's liability as custodian and Euroclear's facilities manager as agent for its members. 38/ As of December 31, 1986, 2,053 banks, brokers, depositories and investment management firms were Euroclear members. Currently, $402 billion in securities, including almost two-thirds of the entire Eurobond market, are on deposit in Euroclear. During 1986, $2.3 trillion in transactions were cleared and settled through Euroclear facilities. This represents approximately 22,588 transactions per day; 96% were settled by book-entry.

37/ The Euroclear system is owned by Euro-clear Clearance System Public Limited Company (U.K.) ("ECS"). Approximately 120 banks, financial institutions and dealers active in international securities markets are ECS shareholders. ECS has administrative offices in Zurich, Switzerland. Morgan Guaranty Trust Company, through its New York and Brussels branches, operates Euroclear's systems under a facilities management contract with ECS. ECS, however, must approve all custodians.

38/ Because Morgan Guaranty (Brussels) is a branch of the Morgan Guaranty Trust Company, it is subject to regulation by the New York and U.S. banking authorities.

Cedel was established in 1970 in Luxembourg and is subject to regulatory oversight by the Institut Monetaire Luxembourgeois (Luxembourg Monetary Authority), the national banking control authority. Cedel is owned by 95 banks and securities houses. Similar to the limitation on ownership placed on Euroclear shareholders, each Cedel shareholder may hold no more than 5% of the issued stock. Cedel's 1,400 members are a geographically diverse group of banks, depositaries and securities firms. Cedel currently has $150 billion of securities on deposit. During 1986, $1.2 trillion in transactions were cleared and settled through Cedel facilities.

Cedel and Euroclear offer members a broad range of services including an automated delivery versus payment clearing system, book-entry settlement and custody 39/ and related services (*i.e.*, interest and principal collection). 40/ These services are described in greater detail below.

39/ Securities may be deposited on a fungible or non fungible basis, at the participants' option. (Members occasionally are required by their domestic laws to hold securities that can be identified specifically by certificate number and thus may be required to deposit securities on a non-fungible basis.)

40/ Cedel and Euroclear also provide special services for members, such as exercising warrants, processing conversions and distributing allotments.

(a) Clearance and Settlement

Cedel and Euroclear provide clearance and settlement services 41/ to members for trades in eligible securities issues. 42/ At least one day before the settlement date (as determined by the parties at the time of the trade), each party to a trade must submit settlement instructions to the clearing system. The instructions are checked, matched against counterparty instructions and reported back to the parties. The clearing system only will act on matched instructions; thus, unmatched instructions must be resubmitted by one or the other party. On the settlement date, if the seller has sufficient securities on deposit, the clearing system will reduce (debit) the seller's securities account and increase (credit) the buyer's securities account, in accordance with the parties' instructions. 43/ At the same time, the clearing system will debit the buyer's, and credit the seller's, cash accounts, in

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41/ Generally, Euroissue trades settle seven calendar days after the trade. Euroclear and Cedel do not provide trade comparison services. Accordingly, members must communicate (*e.g.*, by phone, cable or telex) after trade execution to verify the terms of the trade. Once agreement is reached as to the terms of the trade, members can proceed to submit settlement instructions to Euroclear and Cedel.

42/ Euroclear has facilities to settle trades in 20 different currencies. Cedel has facilities to settle transactions in 26 currencies.

43/ If the seller lacks sufficient securities to complete the delivery, the seller may be able to borrow securities from other clearing system members. *See* Section C.2.c. *infra*.

accordance with the matched settlement instructions. Settlement is in same-day (i.e., immediately available) funds.

Securities and cash accounts are essentially computerized journal or ledger entries indicating rights to securities and cash. Members receive daily settlement and securities position reports.

Both systems settle securities delivery and payment obligations on a trade-by-trade (instruction-by-instruction) basis. Neither system nets one member's delivery obligation with that same member's anticipated receipt of securities in the same securities issue, among other reasons to minimize losses due to member defaults. 44/ Accordingly, the clearing systems act exclusively in an agency capacity for each member and do not guarantee member payment or delivery obligations, as U.S. clearing agencies do with respect to member trades accepted for settlement through CNS systems. 45/

(b) Securities Custody

Transfer of ownership in securities is accomplished by electronic book-entry movements on the clearing systems in

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44/ In contrast, U.S. clearing agencies offer "net" accounting for settling securities and cash payments. All of a member's obligations to deliver securities in a particular issue can be netted against that member's obligations to accept securities in that issue on the same day ("deliver balance order systems") or, in addition, the net deliver or receive obligations can be netted against any outstanding fails to receive or deliver from previous settlement days in the same issue ("continuous net settlement systems" or "CNS" systems).

45/ *See id.*

Luxembourg and Brussels. The physical securities certificates, however, are held by custodian banks ("depositaries") located around the world. Cedel's network of depositary banks includes 33 institutions and Euroclear's network includes 26 institutions. In each system, all the securities certificates of a specific issue are held by one bank, usually the bank responsible for paying dividends or interest on behalf of the issuer. 46/ Because of the custodian's proximity to the issuer's transfer agent, withdrawals can be expedited and transfer-related losses can be minimized. 47/ Moreover, appointing the issuer's paying agent as custodian for that issue may speed dividend and interest payments, reduce reconciliation and payment claim processing costs, and minimize confusion concerning local tax and transfer requirements.

(c) Bond Borrowing and Lending Program

Euroclear and Cedel also offer their participants a "bond loan" program similar to that offered by U.S. clearing agencies. 48/

46/ Some securities held by the depositary banks are, in turn, deposited with a clearing agency in their home country. For example, Morgan Guaranty, as depositary for Euroclear, uses the Depository Trust Company, as its sub-custodian. Additionally, certain securities in book-entry form are held in local national book-entry systems, analogous to the U.S. Federal Reserve System's book-entry system.

47/ For example, risks of loss or theft, and related insurance and shipping costs, can be reduced dramatically.

48/ In 1981, Cedel expanded its program to permit participants to provide Cedel with standing instructions to monitor participant accounts automatically and to borrow or lend securities as needed.

The clearing systems initiated these programs in response to member demand for securities either to effect short sales or to ensure delivery of securities on settlement date. The programs have reduced the number of "fails" in the Eurobond market. The borrower's obligation to return securities is guaranteed by a syndicate of guarantor banks, in return for which the borrower must pledge adequate collateral to the syndicate in the clearing system. This syndicate determines what collateral borrowers must pledge (e.g., cash and/or securities).

(d) Financing

Euroclear and Cedel also offer financing services to members that participate in the Eurobond market. Many Eurobond dealers use this service to finance their inventory. 49/ As security for these loans, Euroclear and Cedel take a security interest in securities being financed. Euroclear and Cedel also require borrowers to provide collateral, including letters of credit.

(e) Cedel-Euroclear "Bridge"

In 1971, Cedel and Euroclear entered into an agreement to "bridge" the two clearing systems to facilitate the settlement of transactions between participants in each system. Each day, Cedel and Euroclear exchange information, such as member settlement instructions. Thus, settlement of securities and the

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49/ At Euroclear, financing is provided by Morgan Guaranty Trust Company. At Cedel a group of member banks provide financing.

transfer of cash on settlement date between participants of the two clearing systems no longer are dependent on the physical delivery of bonds.

D. International Equity Markets

It has become commonplace to refer to the development of 24-hour trading markets in equity securities. To some extent this characterization is correct. There are now nearly 500 companies whose shares are listed and traded outside their home countries. 50/ This trading occurs both on the floors of foreign stock exchanges and in the OTC market.

While international trading of equity securities exists, that trading is limited, particularly with respect to U.S. securities. First, it appears that very little foreign trading in U.S. securities occurs during U.S. trading hours. Second, conversations with broker-dealer firms indicate that trading in U.S. securities overseas occurs almost entirely among foreign investors and sophisticated U.S. institutional investors. 51/ Third, the amount of trading in U.S. securities that takes place on foreign markets is a small fraction of trading

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50/ Address by John Shad, Chairman, SEC, before the International Association of Securities Commissions, on July 16, 1986.

51/ *See* remarks of Donald Unruh, Vice President, Toronto Stock Exchange ("TSE") at the SEC's Internationalization Roundtable (Summary, Appendix B).

volume in the U.S., 52/ barring unusual overnight news regarding a company. 53/ Home market dominance has been less pronounced for certain foreign securities traded in the U.S. and in the United Kingdom; 54/ nonetheless, the home country tends to remain the primary market and there is no well-developed integrated multinational secondary market for equities as there is for Eurobonds. 55/

52/ Some firms indicate that a great deal of London's volume in U.S. shares occurs on the day futures and options on stock indexes expire (so-called "triple witching hours"), with the U.S. firms guaranteeing the New York Stock Exchange ("NYSE") close for their customers closing out index arbitrage positions and then executing the trades in London after the NYSE closes. This allows the firms to avoid the congestion that occurs at the close on the NYSE on these days.

53/ For example, the ISE indicates that its members reported that on average they traded approximately $46 million daily in U.S. stocks in the first six months of 1987. In addition, traders estimated that during the first part of 1986 the daily volume in U.S. stocks in London's off-exchange market was $100-150 million. See Putka, "Foreign Issues Flood London OTC trade," Wall Street Journal, April 18, 1986, p.24. Both figures represent a relatively small proportion of total volume in U.S. stocks. For example, average daily NYSE dollar volume in May 1987 was over $7.1 billion; on the American Stock Exchange ("Amex") $176 million; and on NASDAQ $1.9 billion.

54/ For example, some American Depositary Receipts ("ADRs") covering United Kingdom shares (e.g., Jaguar) are among NASDAQ volume leaders and trade twice as actively in the U.S. as the underlying shares trade in the United Kingdom. Trading in Canadian shares in the U.S. is also very active. In addition, a recent estimate indicated that about 80% of trading in Swedish shares and over 20% of trading of French shares may occur on the ISE. See remarks of Robert D. Meyjes, Senior Vice President, Citicorp Investment Bank, at the SEC's Internationalization Roundtable (Summary, Appendix B).

55/ Most of the transnational trading in equities occurs via a network of large multinational firms and institutions. See infra Section E.

Recent developments, particularly the deregulation of markets in the United Kingdom, 56/ suggest that the degree of worldwide competition for equity securities may increase in the future. For example, several large foreign firms with substantial amounts of capital have established affiliates in the United Kingdom. 57/ This massive infusion of capital provides the potential for liquid markets in a wide range of international equity securities. In regard to U.S. securities, the new market making activities of affiliates of U.S. broker-dealers in London may encourage the U.S. dealers to pass books 58/ or open institutional orders for execution after NYSE trading hours.

56/ The development of the new United Kingdom regulatory structure (sometimes referred to as "Big Bang") generally is understood to be comprised of four major components: (1) the removal of restrictions on foreign ownership of United Kingdom securities firms (March 1986); (2) the unfixing of commission rates and the abolition of the former London Stock Exchange's ("LSE") prohibition against a firm serving as both broker and market maker (October 27, 1986); (3) the implementation by the ISE of a new screen-based trading system (the Stock Exchange Automated Quotation or "SEAQ" System) (October 27, 1986); and (4) the enactment, in November 1986, of the Financial Services Act, which requires securities firms either to become members of an SRO or to register directly with the SIB.

57/ It also should be noted that Canada and France recently have undertaken to liberalize their rules regarding foreign ownership of financial firms and that Japan has taken some steps to allow greater foreign broker-dealer participation in its markets. _See supra_ notes 7 and 8.

58/ "Passing the book" generally is passing control over a firm's proprietary trading activity from one group of a firm's dealers to another group located in a different time zone. Control over the proprietary position encompasses several components, including location of the inventory, profit and loss accountability and control over immediate trading decisions. Some firms use the term "passing the book" to refer to the passing on of different of these components. As used here, "passing the book" refers to passing only control over immediate trading decisions.

Moreover, with the formation of the ISE as a result of the merger in 1986 of the LSE and the International Securities Regulatory Organization ("ISRO"), 59/ the London market has indicated that it will seek aggressively to attract volume in U.S. and other foreign shares. 60/ As part of this effort, the international equities segment of the ISE is moving to a screen based system called SEAQ International, 61/ similar to

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59/ ISRO was formed in 1985 by the 187 largest Euroequity dealers to protect their interests as "Big Bang" developed. ISRO threatened to set up a rival stock exchange for the world's highest capitalization shares that would have drawn liquidity from the LSE in the large United Kingdom shares. Thus, the 1986 merger averted for the LSE a competing market for international shares. See, e.g., "London Stock Exchange: If You Can't Beat Them Join Them," The Economist, pp.94-95 (September 20, 1986); "Way Cleared for Merger of London Exchange, ISRO," Wall Street Journal, November 13, 1986, p.64.

60/ See Remarks of Jeffrey Knight, President, ISE, at the SEC's Internationalization Roundtable (Summary, Appendix B). The ISE already has had some success, attracting in the three months ended January 31, 1987, over $507 million of volume a day in foreign securities. See "Foreign Equities Make Up Quarter of London Trades," Wall Street Journal, March 10, 1987, p.54. Approximately $46 million of this volume was in U.S. shares. See supra note 53. In this connection, after the ISE's announcement of its intent to close its stock trading floor by 1988, the NYSE first indicated that it might interpret its off-board trading rule (Rule 390) to prohibit trading of NYSE listed stocks on the ISE by NYSE members during NYSE hours, and then indicated that as of this time it had not changed its interpretation allowing such trading. See "Big Board's Strict Interpretation of Rule Causes Furor at London Stock Exchange," Wall Street Journal, March 9, 1987, p. 5; and "Big Board Bows to U.K. on London Exchange's Status," Wall Street Journal, March 13, 1987, p.2.

61/ SEAQ International market makers generally are willing to deal in sizes higher than the minimum displayed. Firm quotes are governed by comprehensive dealing conventions

(footnote continued)

that implemented by the exchange for the domestic shares market. 62/

In addition to these developments, the absence of extraterritorial application of the Glass-Steagall Act permits U.S. and foreign banks to engage in dealer activities for U.S. securities in Europe that would be prohibited in the U.S. In particular, foreign banks may find it tempting to effect directly transactions with their advisory clients rather than to route those orders through U.S. broker-dealers to a U.S. exchange.

(continued footnote)

to which all market makers agree to comply. There are formal market hours that apply to defined international regions during which hours all market makers in such region input quotes to the market. In addition, many firms continue to make firm prices after market hours and these, too, are displayed on the system. SEAQ International, pamphlet published by the London Stock Exchange, September 1986.

SEAQ International now carries about 620 issuers from 14 different countries. There are 46 market making firms from ten countries, including the United States. The ISE plans to upgrade SEAQ International to permit the inclusion of more stocks and market makers, and ultimately plans to replace SEAQ International with a new system on which 200 market makers could display prices for 1,500 non-United Kingdom equities. Nicoll, "London Bids to Become Leading International Share Trading Centre," Financial Times, February 4, 1987, p.1. Thus far, only Japanese and Dutch market makers are submitting trade reports at the end of each day; these trade reports are published on the system's screens. In the near future, the market making firms of other countries will submit reports; ultimately, all member firms will be required to submit trade reports to comply with reporting rules of the SIB.

62/ *See infra* note 82.

Some firms also have indicated that the Commission's short sale rule may drive some volume in U.S. shares offshore. Rule 10a-1 under the Securities Exchange Act, 63/ which is generally designed to prohibit short selling from accelerating a declining market, places certain restrictions on short sales in most equity securities traded on a national securities exchange. The short sale rule uses a tick test that compares the price of a proposed short sale to immediately preceding transactions to determine its permissibility; short sales may be effected only on a plus tick (i.e., at a price above the price at which the immediately preceding last sale was effected) or a zero-plus tick (i.e., at a price equal to the last sale if the preceding transaction at a different price was at a lower price).

In its 1985 Global Trading Release, 64/ the Commission requested comment, *inter alia*, on the application of Rule 10a-1 to short sales effected in international markets, noting that the rule does not contain an exemption for such short sales. In response, the SIA stated that it was unclear whether the rule was ever intended to apply to transactions effected in foreign markets, where the absence of continuous transaction reporting and the difficulty of ascertaining the last sale price for transactions effected at a time when U.S. exchanges

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63/ 17 C.F.R. § 240.10a-1.

64/ *See supra* note 2.

are closed would make compliance difficult. 65/ There is no clear exception from the short sale rule for international trades, and Commission's staff has not seen clear indication that any substantial trading occurs overseas for the primary purpose of avoiding the rule's requirements. The Commission's staff continues to monitor developments in this area.

A final factor that may over time increase overseas trading in U.S. equity securities is the potential emergence of a Euroequity market. As noted above, a variety of factors influenced the development of a vigorous Eurobond market, which continues today and appears to be expanding. If, in turn, U.S. issuers increasingly seek to raise equity capital abroad (*i.e.*, in the so-called Euroequity market), such an occurrence could effect the development of more active secondary trading. For example, if an increasing number of foreign investors hold increasing amounts of U.S. equity securities, these investors may desire to trade those securities in their own countries. Moreover, if those securities were offered pursuant to terms and conditions which effectively precluded their ready resale into the U.S. market, those investors might very well seek to ensure that active, liquid secondary markets developed in

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65/ *See* letter from William R. Harman, Chairman, Federal Regulation Committee, SIA, to John Wheeler, Secretary, SEC, dated October 17, 1985.

London or elsewhere. At the present time, however, relatively few U.S. companies have issued equity securities in Europe. 66/

Despite all of the factors discussed above, there is no clear indication that the basic structure of trading in U.S. securities, focused on home market trading as the pricing mechanism, will change. Nevertheless, the existing degree of international secondary market trading, as well as its potential for increasing, raises a host of questions regarding the operations of multinational firms, the trading, clearance and settlement of international transactions and the ability of regulatory bodies to enforce their laws and regulations. The remainder of this chapter focuses on those questions.

E. Multinational Securities Firms

1. General

This section describes the international operations of several U.S.-based multinational securities firms. 67/ The discussion encompasses a limited survey of U.S. and foreign multinational firms' operations and is not comprehensive either as to the types of firms described or as to their operations. Rather, it is intended to provide a sketch of the current global activities of some large U.S.-based multinational firms. 68/

66/ *See supra* Chapter II.

67/ While this overview focuses chiefly on U.S.-based multinationals, it also highlights significant aspects of the U.S. operations of large foreign-based multinationals.

68/ The information contained in this section is based upon interviews with the U.S. offices of six large U.S.- and twelve foreign-based multinational firms, as well as other publicly available data.

It is difficult to generalize concerning the extent and manner of operation of U.S. multinational firms' international debt, equity and research operations. Each firm trades and provides research in a variety of products and emphasizes different foreign markets to different degrees. In addition, some houses centralize control over positions and trading decisions in their home offices, while others localize control in overseas offices, usually subject to various limitations, such as the amount of capital that may be committed to particular trades. As a general matter, control with respect to trading in a particular security will reside in the office located in the primary market for that security. For example, control over a multinational firm's trading in U.S. government securities most likely would be in the U.S. office.

The bulk of trading in foreign securities in the U.S., both in terms of volume and numbers of securities, occurs over-the-counter, either through NASDAQ or otherwise. Furthermore, while some U.S. exchanges are now linked to foreign markets, transnational transactions generally occur over the telephone in an OTC environment. Finally, the customers for these products and services are largely institutions rather than small individual investors.

2. <u>International Debt Operations</u>

While it is difficult to generalize for all multinational firms' international debt operations, some patterns

emerge. First, the customer base is almost wholly institutional. Second, the multinational U.S. firms, like their foreign counterparts, have offices in Tokyo, London and New York, as well as in other foreign locations. They also all trade a variety of international debt products denominated in a variety of currencies, including Eurobonds, government bonds (U.S., United Kingdom, Japan, West Germany and others) and foreign corporate debt securities. While each firm usually concentrates on particular market segments, such as non-U.S. corporate and government bonds denominated in various major currencies, Yankee bonds, or U.S. government securities, a few multinationals trade virtually the full spectrum of fixed-income and floating-rate corporate and government debt securities.

As a general matter, the U.S. operations of these firms focus on U.S. Treasury 69/ and Yankee bonds, 70/ whereas most Eurobond trading occurs in the Eurobond markets in London. 71/ Indeed, the primary trading markets for debt securities continue to be either the market of the currency in which the security is denominated or the Euromarket, and the multinationals often

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69/ An interesting account of 24-hour trading in U.S. Treasury securities at Merrill Lynch is contained in "A Day--and Night--in the Life of the Global Market," 20 Institutional Investor, No. 4, April 1986, pp.293-294, 302.

70/ According to one source, over 99% of all secondary market trading in Yankee bonds occurs in the U.S.

71/ See supra Section C.

centralize trading in the affiliate located in those markets. In addition, most of the U.S. affiliates of foreign-based firms concentrate on U.S. government securities, 72/ although they also are building corporate securities trading capacity.

The size of international debt security positions can be significant, reaching as high as $1 billion. The number of personnel committed to this area of the multinational firms' operations varies, ranging from seven traders to as many as 72 in some overseas offices.

The manner in which multinational firms manage their proprietary positions also varies, although some generalization is possible. Some firms "pass the book" 73/ for debt instruments that are traded in multiple markets, with profit and loss accountability and inventory generally remaining in the office located in the primary (*i.e.*, most active) market for each particular security. After the book passes, traders located in the primary market office will communicate with other offices to assure that trading is conducted properly. For example, the book for Eurobonds will be passed from London to New York to Tokyo. London, as the primary market, will be the profit and loss center and inventory will be maintained there. Because

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72/ The Federal Reserve Board recently named as primary U.S. government securities dealers the U.S. affiliates of Nomura and Daiwa, two of the so-called "Big Four" Japanese securities firms. (The other two are Nikko and Yamaichi.)

73/ *See supra* note 58.

little Eurobond trading occurs in the U.S., monitoring of the book in New York after it is passed will be largely perfunctory. When the book is in Tokyo, traders there will communicate with those in London before undertaking major commitments. For U.S. government securities a similar arrangement might prevail, with the New York office being the home or primary market.

Other firms that also pass the book retain ultimate authority over size of position and profit and loss accountability in the firms' home country rather than in the primary market for the security. Still another variation is to pass the book for multiply-traded debt securities and provide complete discretion over the firm's entire position to the office where trading is occurring. Profit and loss is determined product-by-product and there is no one individual profit center.

While most firms thus pass the book for various fixed income products to some extent, one firm indicated that it totally decentralizes overseas operations, with trading occuring almost exclusively in the firm's primary market office only and inventory being located there. Even under this type of arrangement, however, some instruments (e.g., U.S. Treasuries) may trade in more than one office. This firm expects to integrate its global efforts eventually. 74/

74/ Because the Japanese firms located in the U.S. concentrate on U.S. government securities, their operations tend to be more uniform. The U.S. offices of these firms are

(footnote continued)

3. <u>International Equity Operations</u>

While the international equity trading operations of multinational firms are as varied as the fixed-income operations, again some generalization is possible. First, the equity trading operations of these firms are less well developed than their debt activities, reflective largely of the fact that development of international equity offerings markets, which is usually a precursor to active secondary market trading, has lagged behind the evolution of international debt offerings markets. Nonetheless, the multinationals all have equity operations in London, New York and Tokyo as well as other major markets in Europe and Asia. A few firms also have South American operations.

For the most part, the international equity operations of these firms originated as arbitrage desks, designed chiefly to capture price differentials between U.S. and foreign markets in equity securities (or receipts for those securities, <u>e.g.</u>,

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(footnote continued)

largely autonomous, although the London and Tokyo U.S. Treasury desks of these firms do communicate with the New York office. Indeed, one Japanese firm has completely separate New York and Tokyo books and inventories for U.S. Treasuries, because the offices serve different client bases and because the markets move in different directions during New York and Tokyo hours. The segregation is so complete that the Tokyo book has a representative in New York to trade for the Tokyo book. This allows the Tokyo book to trade 24 hours a day. The New York book does not have a trader in Tokyo, but does leave instructions in Tokyo after New York closes on how to trade the New York book if the market moves beyond certain parameters. This firm indicated that it expects to implement global accounting for its U.S. Treasuries book soon.

ADRs). From this beginning, international equity desks of the multinationals have evolved into more general dealer, agency and research operations. 75/ In the initial phases of that evolution, the primary focus often has been on the equity securities of the home base country, with a secondary emphasis on agency services in foreign securities for home base customers. The capacity to deal in and provide research for foreign securities usually comes later in this evolution. Thus, the Japanese and many of the British firms doing business in the U.S. focus their equity business on Japanese and United Kingdom equities, respectively, and in addition provide agency execution services to their parents' Japanese and British customers in U.S. securities. 76/ As with the debt side, the size of these equity operations varies, with some

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75/ Research is discussed separately in the next section.

76/ With the increase of Japanese investors' interest in U.S. equity securities, due in part to decreasing yields on U.S. government securities, this part of the Japanese firms' business has grown dramatically. During the first quarter of 1987, the Japanese have traded a total of $17,728 million of U.S. equities, compared to $9,863 million during the last quarter of 1986. Moreover, net purchases by Japanese investors have increased from $688 million in the last quarter of 1986 to $3,495 million in the first quarter of 1987. Securities Industry Association, Foreign Activity, Volume X, No. 4, June 19, 1987, p.5. See also "Japanese Lifetime U.S. Investment," 15 Pensions and Investment Age, March 23, 1987, p.1. One major Japanese firm recently decided to direct the equivalent of $10.4 billion of its customers' investments into non-Japanese (mostly U.S.) equity securities. This would represent an eight-fold increase over this firm's 1986 activity in U.S. equity securities.

of the major multinationals having as many as 300 to 400 professional personnel in offices located in foreign markets. The customer base for these international equity services is largely institutional.

There is some similarity in the way trading is coordinated among the foreign and domestic offices of the multinationals. First, the home country markets for even world-class international equities continue to be the primary markets, 77/ and orders received in foreign offices often may be routed there for execution. Nonetheless, active trading does occur in the various desks not located in the home country for these securities and in the organized (generally exchange) foreign markets for some securities. Indeed, U.S. markets for ADRs on several United Kingdom shares exhibit greater volume than reported in the United Kingdom for the underlying share. 78/

Even where foreign desks are active, many firms centralize management in the firm's home country, with that office exercising day-to-day control over profit and loss and inventory. The overseas affiliates, however, necessarily are often free to make day-to-day trading decisions because of the difficulty in consulting with the home office after-hours. In essence, these firms are allowing their London, Tokyo and New York desks increasing autonomy, with the book passing from time zone to time zone.

77/ See supra Section D.

78/ Id.

Some U.S. multinational firms follow a different pattern, centralizing management in the primary market country rather than in New York. For example, the London and Tokyo offices will trade largely United Kingdom/European and Japanese stocks, respectively, 79/ with the book passing during the off-hours of these offices but with the London and Tokyo offices retaining control over size of position, profit and loss, and inventory. 80/

Interestingly, the Japanese multinationals tend to employ a different structure, with the total capital committed to various overseas equity operations controlled by the home country parent, but with the foreign offices operating virtually autonomously in terms of day-to-day management and trading decisions.

The multinationals all depend upon various sources of market information for equities, primarily, of course, relying upon the vendor services available in the different national

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79/ This is not to suggest that U.S. firms do not make markets in U.S. stocks abroad. Indeed some U.S. firms are aggressively establishing dealer operations in U.S. securities in the United Kingdom's new international equities markets. *See supra* Section D. Nonetheless, to date, as with securities of other countries, the U.S. remains the primary market for U.S. securities.

80/ While most multinationals follow one of these two patterns -- with management centralized either in the home office or in the primary market office, and with the book passing, at least one U.S. firm has centralized management of its international equity operations in London.

markets. 81/ For the most active and highly-capitalized U.S. equity securities there is real-time price quotation and volume information, 82/ and, in the United Kingdom, there is now similar information for the 105 "alpha," or the most actively traded United Kingdom securities. 83/ Far less information is available in other markets, and the information

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81/ *See* Rules 11Aa3-1, 11Ac1-1 and 11Ac1-2 under the Securities Exchange Act, 17 C.F.R. 240.11Aa3-1, 11Ac1-1 and 11Ac1-2, relating to transaction and quotation reporting and vendor display requirements.

82/ For "alpha" stocks, market makers show firm, continuous two-way prices, and all trades are published immediately on the ISE's SEAQ system. *See supra* note 61. The information is then disseminated by TOPIC Services, Inc. ("TOPIC"), the Exchange's electronic data dissemination service, which is available in the U.S. In other less actively traded stocks, called "beta" stocks, of which there are 547, market makers display continuous two-way quotations, but the trades are not published until the end of the day. There also are 1,436 "gamma" stocks, relatively inactive stocks in which market makers show continuous two-way quotes, but for which prices may be indicative rather than firm and for which trades are reported but not published. The minimum quotation size on SEAQ is 1,000 shares, for both bid and ask prices. Market makers' quotes generally are for 25,000 shares and may go up to 100,000 shares, depending on the stock. For blocks of shares greater than the quoted number of shares, potential buyers and sellers must contact directly the quoting market makers to arrange a sale. By the end of 1987, however, the ISE anticipates installing a screen-based block order exposure system, in which member firms will input large orders for display. The ISE also has a SEAQ International service for international equities. *See supra* Section D.

83/ These services not only provide means to receive information, but also to disseminate information. Thus, firms can quote markets electronically around the world without a physical presence outside their home country. The regulatory issues raised by this are discussed *infra* Section E.5.

that is available is not consolidated globally. 84/ Thus, most firms will maintain an assortment of vendors' services and machines in their international trading rooms, in addition to relying upon less formal sources of market information (e.g., local telephone contacts in different markets). 85/

Like the international fixed-income desks, the multinationals' equity operations coordinate closely with these firms' foreign currency operations. These firms generally have the capacity to quote and execute trades in the home country currency of many different world-class equities.

4. Research

The international research capacity of the multinationals has just begun to develop, representing a later stage in the evolution of these firms' overall international equity operations. United Kingdom fir4l were the single exception; at an early stage, they developed sophisticated research capacities for non-United Kingdom securities, at first principally U.S. securities.

84/ At least one vendor, however, disseminates globally information on equities from numerous different exchanges. Although the information can be provided on one single page, the quotes are not consolidated, and moreover, are denominated in the currency used on each exchange.

85/ Some multinationals do indicate that they seek to obtain some rough measure of global best execution for world-class securities, endeavoring to check other foreign markets open at any one time to ascertain the best price. Because of differences in quotation practices, foreign currency conversion problems, and vastly different clearing and settlement and other transaction costs, this is an extremely difficult assessment to make. In part because of this, some firms indicate they do not attempt to undertake it.

Other multinationals now are devoting increasing attention to international research; indeed, most now have analysts located in Tokyo, London, New York and other major markets. The research being produced is increasingly global in scope, designed to provide coverage of all the major companies worldwide in particular industries. Thus, while analysts located in the home country of an issuer still will be primarily responsible for research on that issuer, the multinationals aim ultimately to integrate these reports into one worldwide report on specific industries. With the advances in telecommunications, firms are now able to disseminate research reports worldwide electronically, via either their own internal systems or various vendor services, so that almost instantaneously globally disseminated research reports are becoming available. 86/

5. Regulatory Oversight

(a) Financial Responsibility

Regulatory oversight of large multinational firms actively conducting a securities business in many different countries is difficult. Perhaps the chief concern is to ensure the financial integrity of these firms. 87/

86/ *See infra* for the regulatory concerns raised by this capability.

87/ *See, e.g.*, remarks of Robert Birnbaum, President, NYSE, at the SEC's February 17, 1987, Internationalization Roundtable (Summary, Appendix B).

Although the staff is not presently aware of specific problems, the increased internationalization of securities markets has raised concern about the ability of the Commission and the SROs to ensure the financial integrity and responsibility of U.S. registered broker-dealers. The Commission and the SROs lack the authority to examine and regulate the activities of unregistered overseas affiliates of U.S. registered broker-dealers. 88/

It should be noted that the Commission does not have the authority to extend its recordkeeping rules, Rules 17a-3 and 17a-4 under the Securities Exchange Act; 89/ the net capital rule, Rule 15c3-1 under the Securities Exchange Act; 90/

88/ Many major international securities firms are organized as holding companies which own all of the stock of related entities conducting business in specific securities markets worldwide. The growth of the securities business of U.S. securities firms in Europe and the Far East has increased steadily in recent times. For example, one large U.S. firm, a New York-based holding company with offices in the United States, Canada, England and Japan, increased its revenues from overseas operations as a percentage of total revenues from approximately 5.3% in 1983 to 12.3% in 1985.

89/ 17 C.F.R. 240.17a-3 and 17a-4.

90/ 17 C.F.R. 240.15c3-1. Rule 15c3-1 specifies minimum levels of net capital required to be maintained by a registered broker-dealer, based on the nature of the broker-dealer's business. The amount of required net capital is expressed as a ratio or percentage of a firm's aggregate indebtedness, or alternatively, its customer debits or receivables. Aggregate indebtedness is a defined concept that includes most monetary liabilities of a broker-dealer. For broker-dealers using the aggregate indebtedness method, aggregate indebtedness may not

(footnote continued)

or other financial responsibility rules to non-registered broker-dealers, who may be affiliated with registered broker-dealers.

The Commission's net capital rule does provide some safeguards to protect the stability and integrity of a registered U.S. broker-dealer from the defaults of its affiliates. Should a U.S. registered broker-dealer guarantee the obligations of its affiliates, the Rule requires it to consolidate in a single computation the assets and liabilities of that subsidiary or affiliate. In this instance the SRO would have access to examine the activities of the registered broker-dealer and the activities of its guaranteed affiliate.

In addition, paragraph (e) of the Rule prohibits the withdrawal of equity capital by a registered broker-dealer if the withdrawal would cause the firm's level of net capital to decline to certain prescribed "early warning" levels (which are in excess of minimum net capital levels). It thus provides a prohibition against the withdrawal of capital to benefit an affiliate experiencing financial difficulty if such withdrawal could possibly endanger a registered broker-dealer's financial stability.

(footnote continued)

exceed 1500% of net capital or, stated another way, the firm's net capital must be at least 6 2/3% of its aggregate indebtedness. The second or "alternative" method is based on customer debits (i.e., customer receivables) as calculated under Rule 15c3-3, 17 C.F.R. 15c3-3, and requires a broker-dealer to maintain net capital equal to 2% of aggregate customer debits.

Registered broker-dealers often transact business with affiliated unregistered companies creating a receivable due from the affiliate to the registered broker-dealer. Unsecured receivables from an affiliated company are not deemed to be includable assets for net capital computation purposes. Thus, some protection from fictitious or dishonest intercompany transactions is provided by this provision in the Rule. Because of its limited jurisdiction, the Commission staff has found it extremely difficult to trace the movements of funds and securities necessary to reconstruct transactions between affiliates. To alleviate this problem, the Commission recently amended its net capital rule to provide that any secured receivable from an unregistered affiliate be deducted from net worth unless the affiliate makes available upon request its books and records to the Commission and/or the registered broker-dealer's Designated Examining Authority. 91/

A recent proposal for relating minimum capital requirements to the risk profiles of banking organizations, developed jointly by representatives of the Bank of England, the U.S. Office of the Comptroller of the Currency and Federal Reserve

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91/ See Securities Exchange Act Release No. 24553 (June 4, 1987), 52 FR 22295 (June 11, 1987). A Designated Examining Authority is the SRO designated by the Commission to examine a broker-dealer to ensure the broker-dealer is complying with the Commission's financial responsibility rules.

Board, illustrates cooperation between governments that can enhance global regulation of financial markets through the adoption of uniform rules. 92/

(b) Foreign Broker-Dealers' Activities in the U.S.

Securities Exchange Act Section 15(a) requires any broker or dealer who uses the mails or any means or instrumentality of interstate commerce ("the jurisdictional means") in effecting any transaction in or inducing the purchase or sale of any security to register with the Commission, unless otherwise exempted. The definitions of "broker" and "dealer" in the Act apply to "any person" without regard to citizenship; therefore, Section 15(a) applies to foreign broker-dealers using the U.S. jurisdictional means to offer or sell securities within the jurisdiction of the U.S. 93/

92/ The original proposal was released for public comment on January 24, 1987. See 52 FR 5119 (February 19, 1987), 52 FR 18703 (May 19, 1987).

93/ Section 30(b) of the Act excludes the application of the Act or the rules thereunder to "any person insofar as he transacts a business in securities without the jurisdiction of the United States," in the absence of Commission rules explicitly applying these provisions to such person. No rules have been adopted. However, the exemption provided by Section 30(b) has been construed to be unavailable where the transactions occur in a U.S. securities market, Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), rev'd on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub. nom Manley v. Schoenbaum, 395 U.S. 906 (1969); Roth v. Fund of Funds 405 F.2d 421 (2d Cir. 1968), or where offers and sales are made to U.S. citizens or in the U.S. to facilitate sales of securities abroad. SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973).

Application of broker-dealer registration requirements to foreign broker-dealers engaging in business in U.S. markets furthers the purposes of Section 15(a) of the Act of protecting investors and maintaining the integrity of the U.S. securities markets. It assures that investment intermediaries who solicit U.S. securities transactions satisfy basic competency, capital and reporting standards, comply with customer protection requirements, and have consented to U.S. jurisdiction for purposes of SEC enforcement and civil actions.

However, the Commission staff has not required broker-dealer registration in all instances where foreign broker-dealers have employed the U.S. jurisdictional means. In determining when registration should be required, the Commission staff has focused on the degree to which a foreign broker-dealer solicits U.S. investors to purchase or sell securities and on the extent to which that broker-dealer is involved in transactions occurring in U.S. markets. Where the activities of a foreign broker-dealer do not involve U.S. investors or significant participation in U.S. markets, registration of that broker-dealer generally has not been required.

Key to the issue of solicitation is whether the foreign broker-dealer's contacts with U.S. markets reasonably may be viewed as attempting to induce an investor's purchase or sale of a security. The staff historically has taken a strict view of what solicitation entails. The staff has considered activities such as placing advertisements in the U.S. newspapers or hosting

an investment seminar in the U.S. to constitute solicitation and thus to require broker-dealer registration for a foreign broker-dealer. 94/ However, several recent Commission and staff actions have adjusted these positions somewhat in light of the increasing internationalization of the marketplace accomplished in part through electronic linkages of foreign and U.S. exchanges. The Commission has sought in these actions both to accommodate the growing internationalization of the securities markets and to carry out its primary obligation to protect U.S. investors.

First, on April 21, 1986, the Commission approved a pilot program jointly undertaken by the NASD and the ISE that makes certain market information, including securities quotations by market makers, available in both Great Britain and the U.S. 95/ Shortly thereafter, the Commission's Division of Market Regulation issued a temporary no-action position with respect to the ISE/NASD quotation link, allowing the quotes of foreign marekt makers entered into the ISE's SEAQ system to be disseminated in the U.S. through the NASDAQ system and trades resulting from those quotes to be executed without either the foreign market

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94/ See letter from David J. Romanski, Attorney, Office of Chief Counsel, Division of Market Regulation, to Hugh Seymour, Hoare & Govett, Ltd., dated September 28, 1973.

95/ See discussion infra Section F.1. on Market Linkages; Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989.

makers or the ISE registering as broker-dealers. 96/ In issuing this letter, the staff maintained that there were substantial grounds for concluding that the foreign market makers, with the aid and assistance of the ISE, were effecting transactions in securities for purposes of Section 15(a) of the Act. Further, the staff emphasized that any activities resulting in substantial U.S. contacts or involving the solicitation of U.S. investors other than through the entry of quotes through NASDAQ were expressly beyond the scope of the letter. 97/

96/ See letter from Mary Chamberlin, Chief Counsel, Division of Market Regulation, to Frank J. Wilson, Executive Vice President and General Counsel, NASD, dated May 7, 1986. This position has been extended several times, most recently until December 31, 1987. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Frank J. Wilson, Executive Vice President and General Counsel, NASD, dated June 9, 1987.

97/ The provision of quotes on foreign exchange-traded securities was also addressed in a November 1986 temporary no-action letter granted to members of the ISE that are market makers in ISE-listed securities and that make their quotes and other information available to U.S. subscribers of TOPIC. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Richard B. Smith, Davis, Polk & Wardwell, dated November 28, 1986. The nature of the information made available through TOPIC was substantially similar to, though more extensive than, that provided through NASDAQ under the pilot program, including quotes on a wider range of financial instruments. The no-action letter permitted recognized market makers in ISE-listed equity securities to display via TOPIC terminals in the U.S. competing two-way quotations as they were reported in the ISE's SEAQ system. The TOPIC letter did not cover a SEAQ market maker if it engaged in direct solicitation activity in the U.S., as distinct from quotes disseminated through TOPIC. It also did not apply to a SEAQ market maker providing analytic or research reports to U.S. investors through TOPIC or otherwise. This temporary no-action position has been extended until December 31, 1987. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Richard B. Smith, Davis, Polk & Wardwell, dated June 3, 1987.

Second, in August 1986, the Commission granted an exemption from broker-dealer registration to Vickers da Costa Ltd., a U.K. broker-dealer, its Tokyo branch office, and Vickers da Costa (Hong Kong) Ltd. (collectively, "Vickers Overseas"), all subsidiaries of Citicorp. At that time, another Citicorp subsidiary, Citibank, N.A., intended to acquire 80% of Vickers da Costa Securities, Inc. ("Vickers NY"), a registered U.S. broker-dealer and NASDAQ market maker. However, the Glass-Steagall Act prevented Citibank from owning Vickers NY while Vickers NY continued its business of dealing in foreign securities and ADRs. 98/ Vickers NY therefore entered into a contractual agreement with Vickers Overseas in order to maintain Vickers NY's presence as a NASDAQ market maker in foreign securities. Pursuant to this agreement, Vickers NY would execute, on a riskless principal basis, any orders received from U.S. customers against standing buy and sell orders provided by Vickers Overseas. 99/ Thus, Vickers NY's quotes in NASDAQ would always

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98/ The Glass-Steagall Act prohibits a bank from dealing in securities, and limits a bank's securities activities to those of selling securities "without recourse, solely upon the order, and for the account of, customers . . ." 12 U.S.C. 24 (1982). In addition, a bank is prohibited from association with any entity engaged in the business of "issuing, underwriting, selling or distributing . . ." securities. 12 U.S.C. 378 (1982).

99/ This arrangement was approved by the Comptroller of the Currency. *See* letter from Judith A. Walter, Senior Deputy Comptroller for National Operations, Comptroller of the Currency, to Ellis E. Bradford, Vice President, Citibank, N.A., dated June 13, 1986.

reflect a previously entered firm order from Vickers Overseas in order to eliminate any principal risk that might be incurred by Vickers NY. 100/

In the Vickers letter, the Commission allowed Vickers Overseas to support Vickers NY's market making activities in the manner proposed without requiring Vickers Overseas to register as a broker-dealer, but imposed conditions to add further safeguards. The Commission addressed concerns that Vickers NY would be a sham broker-dealer by eliciting a representation from Vickers Overseas that it would provide Vickers NY with weekly "not held" buy and sell orders 101/ in sufficient size to permit Vickers NY to engage in normal market making activities. Moreover, the Commission required Vickers NY to satisfy additiona net capital requirements intended to ensure its ability to meet its settlement obligations even upon failure of Vickers Overseas. In addition, Citicorp represented that information regarding the trading activities of Vickers Overseas would be made availabl to the Commission in connection with any investigation. Further,

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100/ Letter from Jonathan Katz, Secretary, SEC, to Marcia MacHarg, Debevoise & Plimpton, dated August 13, 1986.

101/ Vickers Overseas gave Vickers NY orders to buy and to sell specified amounts of each stock in which Vickers NY was a market maker at prices determined by Vickers NY. If the price moved outside a specified range, however, Vickers Overseas reserved the right to change its orders.

Vickers Overseas agreed to limit its securities activities in the U.S. to those enumerated in the letter. Vickers Overseas was deemed to be a customer of Vickers NY, as were all of its customers, and Citicorp represented that Vickers Overseas would not engage in any business with U.S. citizens.

The ISE/NASD linkage and the Vickers arrangement are two examples of increased international broker-dealer activities. As the cross-border trading of securities increases, broker-dealers outside the U.S. increasingly will seek access to the U.S. capital markets, and, in particular, will seek to effect transactions in foreign securities with U.S. investors. As discussed, in the past, the Commission staff generally has concluded that all forms of solicitation of U.S. investors require broker-dealer registration in the U.S. However, in light of changing trading patterns, the Commission staff is considering closely the registration implications of a wide range of contacts with U.S. investors initiated by foreign broker-dealers. For instance, as discussed, the Commission staff has allowed foreign market makers to disseminate quotes in the U.S. under the aegis of the ISE while indicating that supplementing these quotes with other forms of solicitation may require broker-dealer registration for these firms. The Commission staff is considering what other contacts with U.S. investors justify requiring registration for firms disseminating quotes in the U.S. through the ISE.

The U.S. broker-dealer registration requirements also may pose significant difficulties for firms seeking to trade with U.S. investors directly from overseas. 102/ Registration is problematic for these foreign firms because their entire overseas operations would become subject to U.S. broker-dealer requirements, such as the net capital and customer protection rules, confirmation rules, recordkeeping and reporting requirements and special service of process provisions, potentially conflicting with home country practices or regulation.

The Commission staff is considering how to accommodate these concerns. In particular, the Commission staff is considering whether the overseas trading operations of foreign broker-dealers should be permitted to have minimal contacts with U.S. investors without registration if those contacts, and any resulting transactions, involve a registered U.S. broker-dealer affiliate. Under this approach, the U.S. affiliate would be responsible for the orders from U.S. customers ultimately executed with the overseas trading desk of the foreign broker-dealer. The Commission staff is considering what conditions are necessary to protect U.S. investors trading in this manner with foreign broker-dealers,

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102/ A foreign broker-dealer engaged in U.S. securities activities may register with the Commission or may create and register an American affiliate or subsidiary, as is more commonly done. However, foreign firms may wish to deal with U.S. investors from their central trading desk located overseas, because of this desk's control of minute-by-minute trading and superior contact with overseas markets.

to guard the integrity of U.S. markets, and to maintain the Commission's enforcement powers with respect to this trading activity. In the longer term, the Commission staff is weighing whether some form of reciprocal recognition of international broker-dealers might be developed with other national securities regulators.

F. U.S. Self-Regulatory Organization Initiatives

1. Market Linkages 103/

Although much of the growth in transnational trading has occurred in the international over-the-counter markets, 104/ U.S. exchanges have attempted to capture some international order flow by entering into trading linkages with foreign markets. 105/

In 1984 the Commission was asked to approve the first such trading link, between the Montreal Stock Exchange ("ME")

103/ There also are international market links between U.S. and foreign commodity exchanges. These include: (1) the Chicago Mercantile Exchange/Singapore International Monetary Exchange link for foreign currency futures; (2) the proposed Chicago Board of Trade/London International Financial Futures Exchange link for U.S. Treasury securities futures, and (3) the gold futures link between the Commodity Exchange, Incorporated, and certain foreign markets including the Sydney Futures Exchange. It should be noted that these are not trading links, but arrangements to allow fungible contracts to trade on the linked markets and to clear through a common clearing entity. *See* discussion of the Philadelphia Stock Exchange ("Phlx") and ISE link, *infra* note 118.

104/ *See* Section D. *supra*.

105/ The intermarket surveillance and information sharing agreements covering these linkages are described separately in the following section.

and the Boston Stock Exchange ("BSE"). 106/ During the first phase of that link, ME members were able to direct marketable limit orders 107/ to the BSE floor in approximately 40 U.S.-listed Canadian stocks (or stocks trading in the U.S. pursuant to unlisted trading privileges) then currently trading in the Intermarket Trading System. 108/ Orders were transmitted to the BSE floor through electronic terminals on the ME floor and were routed to the appropriate specialist on the BSE floor for execution. In 1985, the Commission approved an expansion of the link to enable ME members to transmit orders in certain designated stocks directly to the appropriate BSE specialist, using the Montreal Stock Exchange's Registered Representative Order Routing and Execution System ("MORRE"), the ME's automated small order execution system. 109/ Also during this second phase

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106/ See Securities Exchange Act Release No. 21449 (November 1, 1984), 49 FR 44575.

107/ Marketable limit orders are orders to buy or sell securities at the quoted offer or the bid, respectively, or better. Limit orders were not accepted during the initial phase of the link.

108/ The Intermarket Trading System ("ITS") is a computerized communications system designed to link participating market centers by routing messages between them so that participants in one market center can communicate with participants in other market centers in order to purchase or sell stock.

109/ See Securities Exchange Act Release No. 21925 (April 8, 1985), 50 FR 14480. Until modifications to the MORRE system are completed, these orders will be routed to the BSE specialist by a private data processing firm.

the BSE's execution guarantee rule, which requires BSE specialists to accept and guarantee all agency orders from 100 to 1,299 shares, was extended to apply to link trades. During both phases of the link the ME has agreed to guarantee its members' trades. From June 1985 to June 30, 1987, the six ME participants eligible to process trades through the link had completed 11,085 trades representing 5,294,865 shares.

The Commission approved the first trading linkage between a primary U.S. market and a primary foreign market in 1985. The Amex and the TSE proposed a link to permit order flow to be routed between the two exchanges in securities dually listed on the Amex and the TSE. 110/ The exchanges commenced trading in September 1985 on a pilot basis with seven dually listed securities. The number of eligible issues has increased to 17. The exchanges intend to expand this number to 34, the total number of dually listed securities.

The Amex and the TSE each displays on its trading floor the quotes distributed by the other exchange in linkage stocks. Both exchanges also display the best U.S. dollar/Canadian dollar exchange rates quoted by currency dealers on the TSE. In addition, the Amex has developed a mechanism for displaying on the Amex floor a composite quote showing the TSE price simultaneously in both U.S. and Canadian dollars. Quotes and

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110/ See order approving the link in Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

orders are transmitted through each exchange's existing automated routing systems. As with the first stage of the BSE-ME link, only marketable limit orders are eligible for transmission through link facilities.

The Amex has provided the Commission with statistics that show relatively low link usage. Cumulatively, through June 24, 1987, 986 southbound trades have been executed on the Amex, representing 1,946,800 shares, while only 118 northbound trades have been executed on the TSE, representing 230,900 shares. The exchanges expect to expand the link in the future to include "away from the market" orders. The exchanges also anticipate that, in time, they will seek Commission approval to expand the list of eligible securities to include securities traded on either exchange and not just those that are dually listed.

The TSE also has entered into a two-way trading link with the Midwest Stock Exchange ("MSE"). The Commission approved the MSE-TSE link in 1986, initially authorizing link trading in six dually-listed stocks. 111/ Eighteen issues currently are eligible for trading through the link. The exchanges anticipate that the link will be expanded to include all MSE-TSE dually-traded securities that are also listed on the NYSE.

111/ *See* Securities Exchange Act Release No. 23075 (March 28, 1986), 51 FR 11854.

Many aspects of the MSE-TSE linkage are similar to the Amex-TSE linkage. For example, only marketable limit orders currently are eligible to be processed through the link. Furthermore, marketable agency orders are guaranteed an execution at the best available quote up to a specified number of shares. Eventually, the exchanges expect to expand the link to include away from the market orders. Each exchange displays quotes from the other exchange on those stocks eligible to be traded through the linkage. The quotes the TSE receives are the national best bid and offer distributed by the Consolidated Quotation System 112/ for any linkage-traded issue that is also traded through the ITS. Quotes received by the MSE represent the best bid and offer on the TSE.

Currently, 20 MSE members use the link for northbound trades and six TSE members direct order flow south to the MSE. According to statistics provided by the MSE for 1986, 219 southbound trades were executed on the MSE representing 263,609 shares. During the same period 32 northbound trades representing 54,700 shares were executed through the link. In the first half of 1987, there were 133 southbound trades representing 225,154 shares and 13 northbound trades representing 17,600 shares.

112/ The Consolidated Quotation System is an arrangement whereby quotations from all United States market centers (including third market makers) are made available through information vendors in a single consolidated data stream processed by the Securities Industry Automation Corporation.

In April 1986, the Commission granted approval for a six-month pilot program testing an automated linkage between the NASD and the ISE. 113/ The linkage provides for the exchange of market data between the NASD and the ISE. Specifically, the NASD's automated quotation system, NASDAQ, displays quotes for the 100 ISE stocks included in the Financial Times Stock Exchange Index and for 188 non-British stocks quoted in the ISE's new SEAQ International system. 114/ The ISE's automated quotation system, SEAQ, displays firm quotes for 200 NASDAQ companies and 70 non-British companies whose ADRs are traded through NASDAQ. Ultimately, the NASD and ISE anticipate the development of a full trading link, including automatic execution

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113/ See Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989. The Commission has extended the pilot program for four consecutive time periods, the most recent of which will expire on August 31, 1987. See Securities Exchange Act Release No. 24544 (June 3, 1987), 52 FR 21781 (June 9, 1987).

The Commission has not yet granted full approval to the quote sharing arrangement. At least one commentator has objected to potential anticompetitive effects of the arrangement. The terms of the NASD-ISE agreement provide for the exchange of information between the NASD and the ISE at no charge and for the subsequent provision of that information to subscribers. Information vendors who also wish to sell this data to subscribers must purchase it from the NASD and the ISE, potentially placing those vendors at a competitive disadvantage.

114/ See supra note 61.

capability. 115/ The NASD also is negotiating a three-way agreement with the Singapore Stock Exchange and the ISE to provide for 24-hour quote dissemination.

In addition to the already approved market linkages discussed above, the Amex intends to enter into a licensing agreement with the European Options Exchange ("EOE") to enable the EOE to provide trading facilities for options contracts on the Major Market Index ("XMI"), 116/ which would be fully fungible with XMI options contracts traded on the Amex. 117/ The Options Clearing Corporation ("OCC") also is conducting negotiations with the EOE to establish mechanisms for the issuance, clearance and settlement of these options. The Amex and the OCC have formally submitted proposals to the Commission seeking approval of these agreements. 118/

115/ Because the linkage is limited to the exchange of quotation information at this time, it is of limited value to professional market participants who already receive the information from a number of information sources, according to James M. Davin, NASD Board of Governors. Mr. Davin believes that the information may be useful to institutional investors. See Summary of Internationalization Roundtable, attached as Appendix B.

116/ The XMI is a 20-stock index that correlates closely, at a 1 to 5 ratio, with the Dow Jones Industrial Average.

117/ The arrangement contemplated by the Amex and EOE is not a communications or trading link, but rather a plan under which the EOE would list and trade XMI options contracts identical to those listed and traded on the Amex.

118/ See Securities Exchange Act Release Nos. 24462 (May 15, 1987), 52 FR 19942 (May 20, 1987) and 24404 (April 29, 1987), 52 FR 16469 (May 5, 1987). The Phlx and the OCC also were negotiating a similar arrangement with the ISE

(footnote continued)

In reviewing proposed trading linkages, the Commission has focused on several issues. The most crucial element in these linkages has been whether adequate provision is made for the sharing of enforcement and surveillance information. The Commission also has considered whether the home country of the linked market has enacted any type of "blocking statute" (legislation that prohibits the provision of information to foreigners under certain conditions). 119/ Finally, the Commission takes into account any inter-governmental information sharing agreements between the Commission and the foreign sovereign with jurisdiction over the linked market. These arrangements are discussed in greater detail in the following section.

(continued footnote)

and the International Commodity Clearing House for the foreign currency options traded on the Phlx, but the Phlx has indicated that it does not expect to pursue those negotiations at this time. In addition, the Commission approved an agreement between the International Futures Exchange (Bermuda) Ltd. ("Intex") and the Pacific Stock Exchange ("PSE"), that allows the simultaneous trading on the PSE and the Intex of futures and options, respectively, on the Financial News Composite Index. The Intex is a computerized marketplace in which quotes are entered and executions take place within the computerized system. Under this arrangement, Intex and PSE members have electronic access to each others' futures and options markets. See Securities Exchange Act Release No. 23795 (November 12, 1986), 51 FR 41884.

119/ *See infra* Section F.2. for a discussion of intermarket enforcement and surveillance sharing agreements and blocking statute concerns.

In addition to considering the adequacy of the information sharing mechanisms, the Commission has insisted that any exchange seeking to link with a U.S. exchange has the ability to discipline its members for violations of its rules governing trades sent by its members through the linkage for execution. Finally, the Commission has examined proposed linkages to determine whether the markets seeking a trading link have similar, or at least do not have conflicting, rules and regulatory structures. The linkages the Commission has thus far approved have involved foreign markets with antifraud laws and investor protection rules similar to those in the U.S. In addition, all of the trading linkages contain provisions protecting exchange members' quotes to a certain degree by providing that market makers from each exchange will be able to have their U.S. dollar quotes displayed on the floor of the other exchange and that the market maker for the stock on the exchange receiving the quotation will use its best efforts to see that no trade is effected on the exchange at a price inferior to that displayed.

2. Intermarket Information Sharing Agreements

One of the major challenges posed by the internationalization of the securities markets is the detection and prosecution of transnational fraudulent activity. Because intermarket linkages increase the integration of trading in U.S. and foreign markets, the Commission has taken the position that approval should be conditioned on the development of routine surveillance and

information sharing agreements among the linked markets. The Commission has also looked for assurances that there are no barriers to the exchange of investigatory information between the relevant foreign regulatory body and the Commission.

(a) Amex and Toronto Stock Exchange

The trades in the Amex-TSE linkage are subject to the routine market surveillance procedure of the exchanges. 120/ There is routine exchange of information between the exchanges, including market surveillance reports and other data essential to the exchanges' surveillance programs relating to the linkage. Additional information is exchanged upon "reasonable request." In investigations of linkage transactions the exchanges have agreed to "cooperate fully" and use their "best efforts" to obtain information from their members. The market surveillance information exchanged remains confidential except to the extent that its disclosure is required for a regulatory proceeding by an exchange or by either the Commission or the Ontario Securities Commission ("OSC").

In connection with this linkage, the Commission was concerned about the Canadian blocking statute, 121/ which enables Canadian officials to limit the information and documents provided to

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120/ The TSE's surveillance capabilities are comparable to those of the U.S. exchanges.

121/ Foreign Extraterritorial Measures Act, Stat. Can., c. 49. See Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

other countries under certain circumstances. The Commission sought and received assurances that: (1) the linkage agreement itself contained adequate information sharing provisions; (2) open channels of communications would be maintained and information and investigative resources would be shared with the OSC; and (3) the Canadian government would be unlikely to use the blocking statute in light of the similarity of the countries' regulatory schemes and customer protection objectives. 122/

(b) The NASD and International Stock Exchange for the United Kingdom and the Republic of Ireland

The NASD-ISE information sharing agreement provides that the NASD will have access to all the regulatory information it needs for purposes of its surveillance and investigation responsibilities concerning securities in the pilot program. The NASD indicates that for several years the ISE has been willing to cooperate with the NASD in the areas of information disclosure, quotation and trading halts, suspensions and resumptions of trading, and the surveillance and investigation

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122/ Letter from Tory, Tory, DesLauriers & Binnington, to Huntley W.F. McKay, Vice President, TSE, dated June 18, 1985; letter from Richard G. Ketchum, Director, Division of Market Regulation, and Gary Lynch, Director, Division of Enforcement, SEC, to Ermanno Pascutto, Director, TSE, dated September 24, 1985; letter from Ermanno Pascutto to Richard G. Ketchum and Gary Lynch, dated September 24, 1985. The information sharing agreements arising from the MSE-TSE linkage are similar and were accompanied by a similar exchange of letters. See letter from Richard G. Ketchum and Gary Lynch to Ermanno Pascutto, dated March 28, 1986; letter from Ermanno Pascutto to Richard G. Ketchum and Gary Lynch, dated May 28, 1986.

of trading in securities of mutual market concern. 123/ The NASD-ISE agreement specifically confirms that the Commission and the United Kingdom will have access to shared surveillance information.

On September 23, 1986, the Commission and the Commodity Futures Trading Commission executed a Memorandum of Understanding on the Exchange of Information with the United Kingdom Department of Trade and Industry ("DTI"). 124/ This agreement is intended to facilitate the sharing of information needed by the parties to enforce their respective laws. It also has created a cooperative environment where both the Commission and the DTI have committed to facilitate the exchange of surveillance information necessary to support the NASD-ISE pilot program. The agreement sets forth standards with which any request for information must comply, the purposes for which the information may be sought (generally, to secure enforcement of applicable laws, rules and regulations), and the confidential nature of any information received under the agreement. 125/

123/ *See* File No. SR-NASD-86-4, Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989 (April 29, 1986).

124/ This Memorandum of Understanding is discussed in detail *infra* in Chapter VII of this Study.

125/ As indicated above, *supra* note 118, the Intex and the PSE have entered into an agreement for the simultaneous trading on the PSE and the Intex of options and futures based on the Financial News Composite Index ("FNCI"). Under Intex's trading regulations, Intex will be authorized to provide information to the PSE, provided that the PSE keeps the information confidential, the PSE uses the information

(footnote continued)

3. International Clearance and Settlement

Market participants consider the need for improved international clearance and settlement to be the critical issue if internationalization of the world's securities markets is to continue. 126/ Problems in this area fall into two broad categories: (1) the lack of international clearance and settlement links to facilitate cross-border settlements; and (2) the existence of widely varying clearance and settlement systems among the world's capital markets.

U.S. clearing agencies have taken a strong lead in forging numerous links with their foreign counterparts and addressing international clearance and settlement issues. The Commission's staff has overseen and facilitated those efforts, on a case-by-case basis, among other ways, through "no-action" letters.

(continued footnote)

solely for surveillance and other regulatory purposes, and Intex's trading member is notified of the PSE's request before Intex transmits the request to the requesting exchange. The PSE also will be obligated to provide Intex information on mutual members as needed by Intex to fulfill its own surveillance and self-regulatory responsibilities concerning trading of FNCI contracts. The Bermuda Minister of Finance has stated that he favors the agreement between the PSE and the Intex for regulatory surveillance and assured the PSE that he foresaw no circumstances that would warrant invocation of Bermuda's Protection of Trading Interest Act of 1981 to frustrate the surveillance sharing agreement between the PSE and Intex. Letter from Mansfield H. Brock, Jr., Financial Secretary for Ministry of Finance, to Pacific Stock Exchange, dated October 20, 1986.

126/ *See*, *e.g.*, Internationalization Roundtable Summary, Appendix B.

(a) Clearance and Settlement Linkages

The establishment of automated clearance and settlement linkages has been critical to the development of the internationalization of the securities markets. Absent established international systems, broker-dealers and their institutional customers often are forced to devote substantial resources to each task related to trade settlement and must effect securities deliveries by physical means, on a trade-by-trade basis.

Prompt and effective communications are essential. Generally, settlement-related information is communicated by telex, telephone, facsimile or mail. Cash and securities are exchanged via transatlantic courier transportation on a transaction-by-transaction basis. The parties to the trade must be sure that no dispute exists concerning the terms of the trade (e.g., security, price, quantity); securities and cash must be readied for delivery and payment; and transfers of securities and cash must be accomplished. If the trade is executed on an agency basis for a customer who engaged an investment manager to make investment decisions and a custodian bank to hold the investment portfolio, extensive communication among these entities (the broker, bank and investment manager) will be necessary before the bank will release funds or securities to the broker (against delivery of securities or payment of funds) on the agreed settlement date.

This physical mode of processing transaction settlements often subjects the parties to costly delays and increased risk

of loss and theft. As demonstrated by the U.S. securities industry in the late 1960s, 127/ settling transactions one-by-one with slow, decentralized communication and delivery facilities taxes the back-office processing capabilities of broker-dealers enormously during high volume trading periods, resulting in increased costs and risks of operational and financial failure. In contrast, the potential benefits of international clearance and settlement links include: centralized communication facilities; automated data processing; immobilization of securities certificates; and, through future enhancements such as netting, reduced money and securities transfers.

Given these advantages, industry participants have agreed on the importance of a viable international clearance and settlement system in minimizing transaction costs and accommodating high-volume trading. What the nature and scope of that "international system" should be, however, remain at issue. To date, the focus has been on the development of linkages among national clearing systems, although increased emphasis also has been placed on achieving greater uniformity within the various clearing systems. 128/

127/ *See* Securities Exchange Act Release No. 13163 (January 13, 1977), 42 FR 3916 (January 21, 1977) (National Securities Clearing Corporation ("NSCC") temporary registration order); Securities and Exchange Commission, "Study of Unsafe and Unsound Practices of Brokers and Dealers", H.R. Doc. No. 231, 92nd Cong., 1st Sess. 13 (1971).

128/ *See* discussion, *infra* Section F.3.(c) *Uniformity of Clearance and Settlement Systems*.

Since 1980, several U.S. registered clearing agencies have pursued clearance and settlement linkages with their foreign counterparts. As described below, these links, until recently, have involved access to U.S. clearing agency services by non-U.S. clearing systems on behalf of their members. Recent efforts, however, have focused on U.S. clearing agencies access on behalf of their members to non-U.S. clearing systems.

(1) Foreign Clearing System Access to or Use of U.S. Clearing Agency Facilities

The majority of the linkages developed to date have been one-way arrangements, which provide non-U.S. broker-dealers and institutional customers with indirect access to U.S. clearing agencies through their domestic clearing entity. Generally, under these agreements the non-U.S. clearing entity either becomes a full member of the U.S. clearing agency, or agrees to be bound, as if it were a member, to most of the U.S. clearing agency's rules, including financial standards and safeguards. The foreign clearing entity effectively "sponsors" its members into the U.S. clearing agency, carrying their accounts and guaranteeing to the U.S. clearing agency the performance of its members' settlement obligations.

The first linkage between U.S. and foreign clearing entities entailed limited, indirect access to the Depository Trust Company ("DTC") through Bankers Trust Company ("BTC"). In 1980, BTC entered into an agreement with the Nominee Amsterdam Stock

Exchange N.V. ("NASE") to provide NASE participants with indirect access to DTC custodial services. The arrangement permitted BTC to maintain securities deposits at DTC on behalf of the NASE and to perform custodial services on behalf of the NASE (such as deposits and withdrawals) in U.S. securities issues traded on the Amsterdam Stock Exchange. 129/

The second arrangement reviewed by the Commission staff involved an agreement between Trans Canada Options, Inc. ("TCO"), the National Securities Clearing Corporation ("NSCC") and the OCC. The arrangement was designed to facilitate U.S. investor access to Canadian securities options markets by providing a convenient mechanism for U.S. investors to settle options transactions in Canadian securities executed on Canadian exchanges. The NSCC and the OCC act as agents for TCO by performing trade reporting and settlement functions in the U.S. and facilitating access by U.S. broker-dealers to foreign markets. TCO did not become a member of the NSCC or the OCC under this arrangement. 130/

129/ *See* letter from Jerry R. Marlatt, Staff Attorney, Division of Market Regulation, to Alan H. Paley, Debevoise, Plimpton, Lyons & Gates, dated July 25, 1980.

130/ *See* letter from Dan W. Schneider, Assistant Director, Division of Market Regulation, to Andrew M. Klein, Schiff, Hardin & Waite, dated March 25, 1982; letter from Richard G. Ketchum, Associate Director, Division of Market Regulation, to Robert J. Woldow, Vice President and General Counsel, NSCC, dated August 18, 1982.

In 1984, the NSCC established the first international linkage in which a foreign clearing entity, the Canadian Depository for Securities ("CDS"), obtained direct access to a U.S. clearing agency. During 1984, the Commission staff issued "no-action" letters concerning CDS participation in NSCC to facilitate CDS members' clearance and settlement of: (1) OTC transactions in U.S. securities; 131/ (2) trades executed on the BSE through the link with the ME; 132/ and (3) trades in U.S. securities executed on the Amex or the TSE through the TSE-Amex trading link. 133/

In 1985, the Commission staff issued a "no-action" letter to the Midwest Clearing Corporation and Midwest Securities Trust Company ("MCC/MSTC") concerning their arrangement with the Vancouver Stock Exchange Services Corporation ("VSESC"). That link provides Canadian broker-dealers access to MCC/MSTC's systems, particularly the National OTC Comparison System, to

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131/ See letter from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated October 24, 1984.

132/ See letter from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated November 26, 1984.

133/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated September 20, 1985.

clear and settle over-the-counter trades in U.S. exchange-listed securities, NASDAQ securities or Canadian-exchange listed securities. 134/ In 1986, MCC/MSTC and the CDS established a link to facilitate clearance and settlement of trades between MSE members and Canadian broker-dealers executed through the MSE-TSE trading link. 135/

MCC and MSTC were the first U.S. clearing agencies to enter into a direct linkage agreement with a European clearing entity. In 1986, MCC/MSTC accepted the ISE as a member to grant access to ISE members who wished to use MCC/MSTC facilities to clear and settle with U.S. broker-dealers their OTC trades in U.S. securities. 136/

The OCC currently is negotiating with the European Options Exchange ("EOE") to establish a link to support EOE member trades in XMI options, which are proposed to be traded on a

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134/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Michael Wise, Associate Counsel, MCC/MSTC, dated September 12, 1985.

135/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Michael Wise, Associate Counsel, MCC/MSTC, dated March 21, 1986.

136/ MCC and MSTC also have reached an agreement to establish a linkage agreement with la Societe Interprofessionelle pour la Compensation des Valeurs Mobilieres ("SICOVAM"). The Commission currently is reviewing the proposed linkage.

fully fungible basis, on the Amex and the EOE. 137/ If approved and implemented, this will mark the first time options traded on U.S. and non-U.S. exchanges will be cleared and settled in an integrated and fungible manner.

(2) U.S. Clearing Agency Participation in Foreign Clearing Organizations

In 1986, the NSCC formed a wholly owned subsidiary, the International Securities Clearing Corporation ("ISCC"), to centralize the development of international linkages. On August 1, 1986, the ISCC filed with the Commission an application to register as a clearing agency. 138/ The ISCC intends to enter into agreements with foreign institutions, such as foreign stock exchanges or clearing agencies, to permit U.S. broker-dealers to clear and settle, at those institutions, transactions executed on foreign exchanges. Foreign broker-dealers also would be able, through the ISCC's facilities, to clear and settle transactions in U.S. securities with U.S. broker-dealers.

137/ See Securities Exchange Act Release No. 24404 (April 29, 1987), 52 FR 16469. See also supra Section F.l. As indicated above, supra note 118, OCC also had been negotiating an agreement with the International Commodity Clearing House Limited ("ICCH") that would have provided for clearance and settlement of the fungible foreign currency options that were to be traded on the Phlx and the ISE in accordance with proposed Phlx-ISE negotiations. The Phlx is no longer actively pursuing those negotiations.

138/ See Securities Exchange Release No. 23514 (August 6, 1986), 51 FR 29184.

In 1986, the Commission's staff issued a no-action letter on a linkage agreement providing U.S. broker-dealers entry into a foreign clearing system (i.e., "outbound" linkage). 139/ The ISCC and the ISE have established clearance and settlement facilities that enable U.S. broker-dealers to clear and settle trades in securities traded on the ISE through ISE facilities. The agreements provide that the ISE will sponsor its members into the ISE, guaranteeing its members' performance of settlement obligations. 140/ The Commission staff's no-action position allows a pilot program to test the operation of the link. 141/

Other outbound linkages, similar to that developed by the ISCC and ISE, have not developed, in part, because of some uncertainty under the Uniform Commercial Code ("UCC"). The UCC establishes, among other things, when and how delivery of securities occurs. The UCC, as adopted in most states, appears to require clearing agencies to maintain certificates in their vaults, in the custody of a U.S.-registered clearing agency, or in a bank subject to examination by U.S. federal or state bank

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139/ See letters from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, ISCC, dated October 10, 1986 and December 10, 1986.

140/ Id.

141/ The ISCC also requested a no-action position on an "in-bound" linkage with ISE (i.e., enabling United Kingdom brokerdealers to clear and settle trades in U.S. securities through U.S. clearing agency facilities). The ISCC and the ISE are still negotiating the terms of that linkage.

regulatory agencies. By its terms, the UCC does not expressly recognize subcustodial arrangements that U.S. clearing agencies may have with foreign entities. In 1985, Illinois enacted amendments to its UCC Article 8, validating deliveries on the books of a registered clearing agency that maintains certificates with a foreign clearing agency under arrangements permitted by the Commission. This amendment represents a significant step toward safe and efficient processing of international securities transactions through two-way interfaces between domestic clearing agencies and their foreign counterparts. Similar changes to New York, Pennsylvania and Delaware law might be one way to facilitate arrangements between foreign custodians and U.S. clearing agencies domiciled or organized under the laws of those states. The Commission has encouraged clearing agencies to pursue such amendments to state laws affecting their proposed international arrangements. 142/

(b) Direct Foreign Broker-Dealer and Bank Membership in U.S. Clearing Agencies

One alternative to physical international settlement or settlement through linkages is direct participation in a foreign clearing entity. In 1985, the Commission approved an OCC rule change that enables foreign securities firms to join the OCC as

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142/ See Securities Exchange Act Release No. 23568 (August 28, 1986), 51 FR 31863.

full members and subjects them to substantially the same requirements as U.S. firms. 143/ OCC sought approval to accept financial reports from Canadian members in accordance with Canadian, rather than U.S., accounting standards. 144/ MCC and MSTC also have accepted three foreign securities firms as members, subject to all of the same membership requirements as U.S. broker-dealers.

(c) Uniformity of Clearance and Settlement Systems

The arrangements described above offer the advantage of granting to foreign market participants access to domestic clearance and settlement systems. Although these arrangements provide substantially improved mechanisms for clearance and settlement of international trades, they do not address the problem of coordinating settlements among foreign clearing entities with widely differing settlement cycles, system capabilities, or financial responsibility and operational standards.

Settlement time frames vary widely among international market centers -- from five days in New York to one month in

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143/ *See* Securities Exchange Release No. 22123 (June 6, 1985), 50 FR 24853.

144/ *See* Securities Exchange Act Release No. 23487 (July 31, 1986), 51 FR 28466 (Notice of the proposal).

France. 145/ For example, U.S. broker-dealer members of ISCC who use the ISCC-ISE link must coordinate U.S. trade settlements with those in ISE's Talisman system, which typically requires trades executed during a two-week "dealing" period to settle delivery and payment obligations on the second Monday after the close of the dealing period. 146/ In contrast, broker-dealers' U.S. trades settle, generally, five days after the trade date.

U.S. market participants often must contend with coordinating settlements in highly automated markets such as the U.S. and Hong Kong with settlements in markets such as Japan and Italy,

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145/ Recognizing the significant differences in settlement procedures and time frames, the ISCC sought and received an opinion letter from the Board of Governors of the Federal Reserve System ("Board") interpreting the application of Regulation T to U.S. broker-dealers' foreign securities trades. Specifically, the Board stated that Regulation T may be relied upon to permit a broker-dealer to receive payment from a customer in a delivery against payment transaction involving United Kingdom or French securities on a date later than 7 business days after trade date if the delay is due to the mechanics of the settlement procedures in those countries. See letter from Laura Homer, Securities Credit Officer, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to Karen L. Saperstein, Assistant General Counsel, ISCC, dated July 8, 1986.

146/ Other settlement cycles average as follows: (1) Australia -- 5 to 10 days; (2) Belgium -- 2 business days; (3) France -- fixed monthly settlement date; (4) Italy -- 3-44 days (because of the 40% fail rate, however, deliveries often take months); (5) Luxembourg -- 5 business days for stocks and 7 business days for bonds; (6) Spain -- 0-3 days for purchases and 110 days for sales.

where clearance and settlement is largely handled physically. Furthermore, trades cleared and settled through U.S. clearing agency facilities are processed in a continuous net settlement system, 147/ while most other clearing systems are delivery versus payment systems 148/ or require their members to settle trades on a trade-for-trade basis. 149/

The growing internationalization of the world's capital markets is introducing new risks to national clearance and settlement systems. Because of the different types of guarantees associated with these settlement systems, loss allocation mechanisms and financial responsibility requirements vary among market clearing organizations. These standards, of course, were developed in the context of purely domestic clearance and settlement activity. Thus, in developing international clearing arrangements, it may be necessary to reexamine member financial responsibility standards in light of clearing systems' increased exposure from international obligations.

147/ A continuous net settlement system is one in which the clearing system nets its members' trades and interposes itself between the original parties to a trade. Settlement is with the clearing agency, which guarantees the trade to each of the parties. *See supra* note 44.

148/ Delivery versus payment systems do not provide a netting system for participants.

149/ Trade-for-trade settlement systems generally do not provide participants guarantees of their securities trades. Participants may use the clearing system for comparison of their trades and delivery but the clearing system's role remains that of an agent to the parties.

Although the development of international clearance and settlement links is clearly a step forward for international securities markets, the lack of uniform clearance and settlement standards still must be addressed. Several multinational organizations are attempting to create uniform or, alternatively, compatible standards and procedures for clearance and settlement systems. 150/ Recently, the International Organization of Securities Commissioners ("IOSC") established a subcommittee on clearance and settlement that is expected to begin discussing many of the problems outlined above at the next annual meeting in September 1987.

4. Exchange and NASDAQ Foreign Issuer Listing Requirements

On June 11, 1987, the Commission approved rule proposals submitted by the Amex and NYSE to enable the exchanges to waive or modify certain corporate governance and financial disclosure listing standards for foreign companies. 151/ Specifically, the

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150/ Industry groups include the International Society of Securities Administrators, the International Federation of Stock Exchanges and the International Operations Association.

151/ Securities Exchange Act Release No. 24634 (June 23, 1987), 52 FR 24230. These proposals did not affect the Amex or NYSE quantitative (*e.g.*, public float, assets, income) listing standards for foreign issuers. To qualify for listing on the Amex or the NYSE, foreign companies must meet either: (1) the same quantitative standards applicable to domestic companies, requiring broad share distribution in the U.S. and specifying size and earnings requirements; or (2) alternative quantitative standards, requiring broad worldwide share distribution and specifying considerably greater size and earnings requirements. Both sets of standards ensure that listed foreign companies are well-established companies whose shares are held widely either in the U.S. or worldwide, thus assuring a substantial following by securities analysts.

Amex and NYSE rule changes permit the exchanges to consider a foreign company's compliance with the laws, customs and practices of the country of its domicile in determining whether the company has complied with the otherwise applicable listing standards. An exception or waiver from exchange listing standards may be granted in any of the following areas: (1) quarterly reporting of interim earnings; (2) composition and election of the Board of Directors; (3) shareholder approval requirements and voting rights; 152/ and (4) quorum requirements for shareholder meetings. Both the Amex and the NYSE require, however, that interim earnings be reported on a semi-annual basis and earnings statements and other reports be available in English. 153/

At the same time the Commission approved an NASD proposal to establish corporate governance standards for NASDAQ/National Market System ("NMS") issuers and to provide exemptions similar to

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152/ The Commission recently instituted proceedings under Section 19(c) of the Act to consider whether to adopt a rule (proposed Rule 19c-4) regarding disenfranchisement of shareholders. See Securities Exchange Act Release No. 24623, June 22, 1987. Proposed Rule 19c-4, as currently drafted, would apply only to domestic issuers. The Commission, however, is soliciting comments on whether the proposed rule should apply to foreign issuers as well as domestic issuers.

153/ Before an exemption or waiver can be granted, the foreign company must provide an opinion from independent counsel that the practices of the issuer are consistent with the laws, customs or practices of its country of domicile.

Amex's and NYSE's for foreign issuers. 154/ The Amex, NYSE and NASD proposals resulted from concern that their requirements (proposed requirements in the case of the NASD) relating to various corporate governance procedures and interim earnings reports could unduly inhibit foreign companies from listing on the exchanges or seeking inclusion 155/ in the NASDAQ/NMS system because some listing standards are either inconsistent with or contrary to the laws, business customs or practices of the companies' home country. 156/ In approving the proposals, the Commission determined that, where the fundamental investor protections of the federal securities laws and SRO rules remain in place, it is appropriate to permit differentiations from the requirements imposed on domestic companies to permit the U.S. SROs to be more competitive on an international basis and to

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154/ Securities Exchange Act Release No. 24634 (June 23, 1987), 52 FR 24230. The approval corporate governance standards require NMS issuers to distribute reports to shareholders with the same frequency as those reports are filed with the Commission. The NASD standards also establish requirements concerning audit committees, independent directors, shareholder meetings, quorums, solicitations of proxies, and conflicts of interest.

155/ The NASD's foreign issuer waiver provision also is intended to discourage foreign issuers that came into the NMS system before the adoption of the NASD's new NMS corporate governance standards, supra note 154, from leaving the system to avoid compliance with these standards where they may be inconsistent with the issuers' home country law or practice.

156/ For example, many Scandinavian companies are required to afford significant board level representation to their employees, which may be in conflict with Amex requirements relating to voting for corporate boards.

provide U.S. investors with investment opportunities in a larger number of foreign securities. 157/

G. Application of Rules 10b-6 and 10b-7 to Multinational Offerings

Rules governing secondary market trading activity during an offering also are implicated by the internationalization of the securities market. In particular, Rules 10b-6 and 10b-7 under the Securities Exchange Act 158/ create issues for foreign companies registering offerings in the U.S. because foreign methods of distributing securities often differ substantially from those utilized in the U.S.

Rule 10b-6 proscribes certain conduct by persons who are participating in a distribution. The purpose of the Commission rule is to prevent persons who are participating in a distribution from artificially conditioning the market for the securities in order to facilitate the distribution. The rule achieves this antimanipulative goal by prohibiting, subject to certain exceptions, persons engaged in a distribution of securities from bidding for or purchasing, or inducing others to bid for or purchase, such securities, any security of the same class and

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157/ In this connection, in its order approving the NYSE and Amex proposals, the Commission noted that currently U.S. members interested in purchasing foreign issues can execute their orders in a foreign market that may offer less protection to investors than those provided in U.S. markets. Accordingly, in the Commission's view, permitting a number of foreign securities to be traded on U.S. regulated exchange markets may actually increase protection for U.S. investors.

158/ 17 C.F.R. 240.10b-6 and -7.

series as those securities, or any right to purchase any such security, from a specified period (2 or 9 business days) prior to commencement of offers and sales in the distribution, until they have completed their participation in the distribution.

The issues raised may be best illustrated by examples of distribution practices in two countries with issuers that have recently raised capital in the U.S., Great Britain and France. In British practice, the underwriters offer investment advice to their clients throughout the offering period. To the extent such advice constitutes an "inducement to bid for or purchase," Rule 10b-6 would be violated. Further, the subunderwriters (essentially, institutional investors) may trade for their own account throughout the distribution. This also could constitute a Rule 10b-6 violation.

In France, transactions generally take place through an agent de change (roughly comparable to a stock exchange specialist in the U.S., although the agent de change cannot take a proprietary position in securities). It is customary for the sponsoring bank (or the issuer) to assist the agent de change for a period of time following a public offering in maintaining an orderly market. 159/ For the issuer or an entity affiliated with an underwriter in the U.S. distribution, this activity would be prohibited by Rule 10b-6.

Rule 10b-7 governs stabilization of the price of a security to facilitate an offering. In the multinational

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159/ See infra note 164.

offering context, the primary application of Rule 10b-7 is the requirement regarding the relationship between the level of any stabilizing bid in a secondary market and the price at which the security is stabilized in its primary market. Further, Rule 10b-7 does not permit a stabilizing bid to be increased. In conjunction, these provisions of Rule 10b-7 may present difficulties resulting from a change in currency exchange rates in the markets where stabilization is conducted.

In 1977, British Petroleum ("BP") offered securities in the United Kingdom and the U.S. The Commission staff issued a letter granting an exemption to the British underwriters to permit them to induce purchases of BP securities (offering investment advice to their clients involving the purchase of BP securities otherwise than in the distribution) if, among other things, such inducements were:

1. In the ordinary course of business;
2. Not for the purpose of creating actual or apparent trading;
3. Not for the purpose of raising the price of any BP security; and
4. Otherwise in compliance with Rule 10b-6. 160/

These restrictions applied until the completion of the distribution in the U.S. The staff took a no-action position without imposing any conditions to allow the British sub-underwriters to continue to trade during the distribution.

160/ See letter regarding The British Petroleum Company Limited (June 14, 1977).

Commission staff also provided exemptive and no-action relief regarding subsequent BP offerings. In 1979, BP offered shares to the public in the United Kingdom; however, nationals of other countries could participate if they met certain qualifications. Any such persons would have to apply for the ordinary shares in Britain in the same manner as if they had been British nationals. There was no U.S. underwriting or dealer group. The staff issued a letter granting relief subject to substantially the same conditions as those imposed in 1977. The principal area of difference was the addition of a condition to the relief granted to the underwriters that transactions resulting from any inducements to purchase be "within the range independently established in the market of independent bid and asked prices prevailing in the relevant market at the time for quantities of the relevant size." 161/

BP offered shares by means of a rights offering in 1981. The offering was made to all BP shareholders, including U.S. holders of ADRs. The staff's letter granting relief was conditioned upon the fact that the British underwriters and subunderwriters agreed not to purchase or sell in the U.S., for delivery therein, any existing or new BP shares, ADRs, or

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161/ See letter regarding The British Petroleum Company Limited (October 31, 1979).

rights to subscribe therefor, other than pursuant to unsolicited orders on a U.S. national securities exchange. This undertaking was included as part of the underwriting agreement. 162/

Exemptive relief from Rule 10b-6 was also granted with respect to offerings of the securities of two French issuers, Louis Vuitton S.A. ("Vuitton") and Rhone-Poulenc S.A. ("Rhone-Poulenc"). In the Vuitton offering, an exemption was granted to allow Banque Paribas, the sponsoring bank (essentially, the underwriter) for the offering of ordinary shares on the Paris Bourse (Stock Exchange) until two business days before the commencement of offers and sales of the ADRs in the U.S. 163/ The exemption was premised on the staff's recognition of the fact that the transactions for which relief was granted were permitted under French law and would be made only at the request of an independent third party (the agent de change) 164/ at prices and in quantities determined by the

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162/ See letter regarding The British Petroleum Company Limited (July 2, 1981). In 1983, BP again offered shares to the public in the United Kingdom as in its 1979 offering. The staff issued a no-action letter on the same basis as its 1979 letter. See letter regarding The British Petroleum Company PLC (Sept. 15, 1983).

163/ See letter regarding Louis Vuitton S.A. (June 21, 1984).

164/ The agent de change is a ministerial government officer, and is somewhat equivalent to a specialist on a U.S. securities exchange except that the agent de change may not trade for its own account. The price of a security on the Paris Bourse may not vary from the prior day's close by more than 4 percent. The inability to trade for its own account is a hindrance to the agent de change

(footnote continued)

agent de change. The U.S. portion was approximately 20 percent of the total offering and was to be sold approximately two weeks after the French portion was sold. The Vuitton ordinary shares would trade on the Paris Bourse during the two week period.

The Commission staff also granted a conditional exemption from Rule 10b-6 in connection with a large offering in France and the U.S. by Rhone-Poulenc. 165/ The U.S. portion of the offering was approximately 20 percent and was to occur concurrently with the French portion of the offering. The exemption was conditioned upon the observance of a nine-day "cooling-off period" by the distribution participants and their "affiliated purchasers." 166/

(footnote continued)

if it appears that an order imbalance is going to result in the 4 percent limit being breached, since the agent de change wishes to maintain an orderly market by avoiding a cessation of trading. In French practice, the sponsoring bank aids the agent de change in this task. Certain of the proceeds of the offering are retained by the sponsoring bank in a special account rather than distributed to the issuer or selling shareholders. This account is also frequently supplemented by the deposit of additional shares by the issuer or selling shareholders. At the request of the agent de change, the sponsoring bank may, but is not required to, trade from this account. The agent de change approaches the sponsoring bank only when an order imbalance exists.

165/ See letter regarding Rhone-Poulenc S.A. (March 13, 1987).

166/ The term "affiliated purchaser" is defined in Rule 10b-6(c)(6) to include persons acting in concert with the issuer, persons controlling the issuer's purchases or whose purchases are controlled by the issuer, and affiliated broker-dealers.

(footnote continued)

A number of recent multinational offerings involving the "privatization" program of the British Government have been conducted subject to essentially the same underwriting conditions contained in the 1979 and 1983 BP letters. 167/ The staff did not issue any letters in connection with these offerings. Rather, the conditions designed to achieve compliance with Rule 10b-6 by the non-U.S. underwriters were contractually imposed by the Orderly Marketing Agreement (essentially an agreement among underwriting syndicates). One such agreement 168/ provides, for example:

> Pending the completion of the U.S. Offering:
>
> * * * * *
>
> (7)(a) each of the U.S. Underwriters shall comply fully with the requirements of Rule 10b-6 under the United States Securities Exchange Act of 1934 ("the 1934 Act");
>
> (b) for the purpose of complying with the said Rule 10b-6, none of the other Underwriters shall bid or purchase

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(continued footnote)

The French underwriters were able to accommodate the nine-day period without difficulty since trading in Rhone-Poulenc securities was suspended on the Paris Bourse for an 18-day period immediately prior to the commencement of the U.S. portion of the distribution.

167/ *See* British Airways, PLC, Reg. No. 33-11195 (February 11, 1987); British Gas, PLC, Reg. No. 33-9888 (December 8, 1986); British Telecommunications, PLC, Reg. No. 2-94003 (December 3, 1984).

168/ British Airways, PLC, Reg. No. 33-11195 (February 11, 1987).

> . . . any Ordinary Shares or ADRs for any account in which it has a beneficial interest or (otherwise than in the ordinary course of business) attempt to induce any person to purchase . . . any Ordinary Shares of ADRs other than purchases from it;
>
> (c) each Underwriter recommending or effecting transactions on behalf of clients in the ordinary course of business (as referred to in Clause 7(b)) shall execute such transactions only within the range of prices independently established in the market at the time for quantities of Ordinary Shares or ADRs of the relevant size, and not for the purpose of creating actual or apparent trading in, or raising the price of, any such securities; and
>
> (d) in order to ensure compliance with Rules 10b-6, 10b-7 and 17a-2 under the 1934 Act [and applicable provisions of the Securities and Exchange Law of Japan], all stabilization activities, if any, on behalf of any of the Underwriters shall be conducted only with the prior consent of [the U.K. and U.S. managing underwriters]. . . .

Most recently, the Commission staff granted a Rule 10b-6 exemption to permit the underwriters of C.H. Beazer (Holdings) PLC ("Beazer") securities to continue their market making activities until two days prior to the commencement of a public offering of Beazer securities in the U.S., even though the Beazer shares trade below $5.00 per share in the United

Kingdom. 169/ The exemption was based on the very significant market captialization of Beazer, the large number of market-makers in Beazer shares, and the substantial trading volume of Beazer shares during the prior calendar quarter.

Relief also has been provided regarding the application of Rule 10b-7 in order to reflect the realities of international offerings. For example, the Commission recently issued two exemptive orders in global offerings to permit stabilizing bids to be placed in markets abroad and in U.S. markets based on the principal market for such securities where the principal market was not in the U.S. 170/ Staff no-action letters have provided that, under certain terms and conditions, stabilizing bids may be adjusted to reflect changes in currency relationships. 171/

H. The Commission's Global Trading Release and Internationalization Roundtable

In recognition of the accelerating movement towards global trading markets for certain securities and the increasing flow of investments across national borders, the Commission,

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169/ Rule 10b-6 permits an underwriter to continue market making until two business days before offers or sales of the security being distributed, if the stock trades at $5.00 or more per share and has a public float of 400,000 shares, or for all other securities, until nine business days before offers or sales.

170/ Phillips N.V., Securities Exchange Act Release No. 24486 (May 12, 1987); Barclays PLC, Securities Exchange Act Release No. 24487 (May 19, 1987).

171/ See. e.g., letter regarding Banco Central, S.A. (June 30, 1987).

in April 1985, issued a release requesting comment on a broad range of issues concerning the internationalization of the securities markets. 172/ To encourage consideration of ways of attaining the fairest and most efficient global secondary markets, the Commission solicited comment on what conditions and structures should characterize international trading markets and the comparison, clearance and settlement of resulting international trades.

In January 1986, the Commission released a staff summary of the 30 comments received in response to the Global Trading Release. 173/ In brief, commentators viewed the tendency for securities to be traded outside their market of origin and for investors to seek investment opportunities in foreign securities or markets as a positive development. They also stated their belief that global trading markets would continue to grow in size and importance, but differed on whether trading through linked exchanges or an upstairs dealer network would predominate. Commentators also recognized that the Commission has an important role to play in the internationalization process, but generally cautioned that international trading markets should be allowed to develop further on their own without extensive involvement of the Commission at this point. Commentators did indicate, however, that the facilitation of intermarket trading linkages

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172/ *See supra* note 2.

173/ The summary is attached as Appendix A.

and international clearance and settlement facilities was an appropriate area for Commission action. Commentators also suggested that the Commission might play a useful role in encouraging agreement among the active trading markets regarding minimum standards for automated clearance and settlement systems.

The Commission considered the Release and comment summary at a public meeting in May 1986, and endorsed the view of commentators that it should proceed cautiously in responding to the growth of transnational trading. The Commission instructed the staff to facilitate the development of international linkages between securities markets and clearing agencies and to ensure that such linkages incorporate adequate market surveillance and information sharing arrangements. In addition, the Commission instructed the staff to discuss with the NASD expanding the scope of NASD after-hours trade reporting requirements. 174/ The Commission also directed the staff to continue discussing with securities markets and market participants issues of concern in the internationalization area, and to organize a roundtable on the internationalization of the securities markets.

174/ Market and clearing linkages and the Roundtable are discussed *supra*. The NASD recently has expanded the scope of its after-hours reporting by requiring that reports of trades executed between 4:00 p.m. and 5:00 p.m. EST be submitted to the NASD by 5:00 p.m., rather than reported manually by the end of the week. *See* Securities Exchange Act Release No. 24512 (May 26, 1987), 52 FR 20656. Trades executed after 5:00 p.m. EST, however, continue to be reported to the NASD weekly on Form T.

On February 17, 1987, the Commission conducted a Roundtable Discussion on Internationalization. A summary of those proceedings is attached as Appendix B to this chapter. The Roundtable participants included experts on many different aspects of internationalization and their remarks confirmed the comments received on the Global Trading Release: (1) international trading markets are expanding and are largely institutional, although home country markets will remain the primary and most liquid markets, particularly for equities; (2) the Commission should not impose regulatory solutions but should facilitate appropriate developments in the market; (3) international clearance and settlement is the largest single problem in this area; and (4) information and surveillance sharing among regulators and markets is crucial.

C H A P T E R V

A P P E N D I X A

Executive Summary

In its April 1985 Global Trading Release ("Release"), the Commission solicited comment on a broad range of issues concerning the increasing internationalization of the world's securities markets. The Release requested comment on what conditions and structures should characterize international trading markets, possibly including international consolidated reporting, consolidated quotations, and intermarket linkages.

In response to the Release, the Commission received thirty letters from commentators from six countries. Commentators viewed the increasing tendency for securities to be traded outside their market of origin and for investors to seek investment opportunities in foreign securities or markets as a positive development. They also believed that global trading markets would continue to grow in size and importance. Commentators recognized that the Commission has an important role to play in the internationalization process, but generally opined that the Commission should refrain from premature action in this area, permitting international trading markets to develop further on their own.

Commentators indicated that market professionals and international investors do the majority of international trading, and will continue to dominate the global markets. Commentators also indicated that trading in those markets generally occurs on an upstairs in-house basis, and involves foreign stocks more frequently than U.S. equities.

While commentators agreed that transnational trading would increase, they differed in their views of what would constitute the future structure of the international securities markets. Several exchanges predicted that future global trading of world class securities would occur around-the-clock through a network of interconnected exchanges, while other commentators asserted that around-the-clock in-house trading by U.S.-based or large foreign securities firms was more probable. Despite differing perspectives, commentators believed that increased dissemination of quotation and trade information would facilitate the growth of global trading markets, although reservations were expressed about the practicability of immediately developing international consolidated quotation and transaction reporting systems. In addition, commentators supported industry development of intermarket linkages as needed.

Commentators generally agreed that efficient, safe, and accurate comparison, clearance, and settlement systems were

necessary for the growth of international trading, and strongly supported additional links between central clearing and depository organizations. Commentators generally indicated that the incremental development of links between existing institutions was preferable to trying to create a central international clearing or depository entity. Commentators further endorsed the current staff practice of determining foreign clearing agency eligibility for international linkage participation through no-action letters.

Summary of Comments

In the Global Trading Release ("Release"), 1/ the Commission solicited comment on a broad range of issues concerning the increasing internationalization of the world's securities markets. The Release requested comment on what conditions and structures should characterize international trading markets, possibly including international consolidated reporting, consolidated quotations, and intermarket linkages. Other issues were clearance and settlement of international transactions, the effect of Exchange Act rules such as Rule 10b-6 on multinational distributions of securities, and international enforcement problems.

The Commission received thirty comment letters in response to the Release. The commentators were eight securities markets, 2/ one futures exchange, 3/ five entities involved in the clearance

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1/ Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302.

2/ See Letter from Richard O. Scribner, Executive Vice President, Legal and Regulatory Affairs, American Stock Exchange, to John Wheeler, Secretary, SEC (December 13, 1985) ("Amex Comment"); Letter from Gerrit H. De Marez Oyns, Secretary General, Amsterdam Stock Exchange, to John Wheeler, Secretary, SEC (June 27, 1985) ("Amsterdam Comment"); Letter from R.L. Coppel, Executive Director, Australian Associated Stock Exchanges, to R.G. Ketchum, Director, Division of Market Regulation (August 14, 1985) ("AASE Comment"); Letter from T.G. Barker, Director-General, Panel on Take-overs and Mergers, London Stock Exchange, to Andrew E. Feldman, Attorney, Division of Market Regulation (May 16, 1985) ("London Comment"); Letter from Gordon S. Macklin, National Association of Securities Dealers, Inc., to John Wheeler, Secretary, SEC (November 4, 1984)("NASD Comment"); Letter from Robert V. Roosa, Chairman, Advisory Committee on International Capital Markets of the New York Stock Exchange, to John Wheeler, Secretary, SEC (June 20, 1985) ("NYSE Comment"); Letter from Shoichi Suzuki, Director, General Administration Department, Tokyo Stock Exchange, to Richard G. Ketchum, Director, Division of Market Regulation (June 29, 1985) ("Tokyo Comment"); Letter from Keith E. Boast, Vice President, Member Regulation, Toronto Stock Exchange, to John Wheeler, Secretary, SEC (July 5, 1985) ("Toronto Comment").

3/ Letter from Thomas R. Donovan, President and Chief Executive Officer, Chicago Board of Trade, to John Wheeler, Secretary, SEC (July 1, 1985) ("CBT Comment").

and settlement of securities transactions, 4/ three pension fund managers, 5/ two banks, 6/ four associations, 7/ one

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4/ Letter from Ronald S. Ritchie, Chairman, The Canadian Depository for Securities Limited, to John Wheeler, Secretary, SEC (August 26, 1985) ("CDS Comment"); Letter from Angus G. Richards, Project Manager, Clearing House Settlement System Development, Joint Exchange Computers Pty. Limited, to John Wheeler, Secretary, SEC (August 6, 1985) ("Australian Clearing Comment"); Letter from Albert M. Anderson, President and Chief Operating Officer, Midwest Clearing Corporation/ Midwest Securities Trust Company, to John Wheeler, Secretary, SEC (October 14, 1985) ("MCC/MSTC Comment"); Letter from Robert J. Woldow, Senior Vice President and General Counsel, National Securities Clearing Corporation, to John Wheeler, Secretary, SEC (September 30, 1985) ("NSCC Comment"); Letter from David R. Sawyier, Sidley & Austin, to John Wheeler, Secretary, SEC (December 10, 1985) (enclosing International Commodities Clearing House Limited's comment) ("ICCH Comment").

5/ Letter from D.A. Lyle, Executive Director, Baring International Investment Limited, to John Wheeler, Secretary, SEC (June 20, 1985) ("Baring Comment"); Letter from Roger G. Ward, Deputy Managing Director, BT Investment Management Ltd., to John Wheeler, Secretary, SEC (June 24, 1985) ("BT Comment"); Letter from Robert Stephens, Vice President, Mellon-Pictet International Management, Ltd., to John Wheeler, Secretary, SEC (June 13, 1985) ("Mellon-Pictet Comment").

6/ Letter from Directorate of Securities & Syndicates, Algemene Bank Nederland N.V., to John Wheeler, Secretary, SEC (May 22, 1985) ("Algemene Comment"); Letter from Anne R. Ronai, Vice President, Bankers Trust Company, to John Wheeler, Secretary, SEC (June 25, 1985) ("Bankers Trust Comment").

7/ Letter from Richard M. Phillips, Chairman, Federal Regulation of Securities Committee, Morton A. Pierce, Chairman, Subcommittee on International Securities Matters, and Lloyd Feller, Chairman, Subcommittee on Securities Markets and Market Structure, American Bar

(footnote continued)

law firm, 8/ one broker-dealer, 9/ one issuer, 10/ an international securities administrators symposium, 11/ two securities regulators, 12/ and one United States government agency. 13/ The views of the commentators are summarized

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(footnote continued)

Association, to John Wheeler, Secretary, SEC (August 30, 1985) ("ABA Comment"); Letter from David Silver, President, Investment Company Institute, to John Wheeler, Secretary, SEC (June 24, 1985) ("ICI Comment"); Letter from Henry L. James, Director General, The National Association of Pension Funds Limited, to John Wheeler, Secretary, SEC (June 28, 1985) ("NAPF Comment"); Letter from William R. Harman, Chairman, Federal Regulation Committee, and Terrence Connelly, Chairman, Corporate Finance Committee, Securities Industry Association, to John Wheeler, Secretary, SEC (October 17, 1985) ("SIA Comment").

8/ Letter from Cary I. Klafter, Morrison & Foerster, to John Wheeler, Secretary, SEC (June 27, 1985) ("M&F Comment").

9/ Letter from Samuel E. Hunter, Senior Vice President, Merrill Lynch Capital Markets, to John Wheeler, Secretary, SEC (September 30, 1985) ("Merrill Comment").

10/ Letter from Walter R. Diehl, Jr., Vice President and Associate General Counsel, ITT Corporation, to John Wheeler, Secretary, SEC (June 27, 1985) ("ITT Comment").

11/ Letter from B. Imseng, Chairman, and K. Menche, Secretary, International Symposium of Securities Administrators, to John Wheeler, Secretary, SEC (June 25, 1985) ("ISSA Comment").

12/ Letter from Louise leBel Chevalier, Secretary, Commission des valeurs mobilieres du Quebec, to John Wheeler, Secretary, SEC (July 26, 1985) ("QSC Comment"); Letter from R.J. Schoer, Executive Director, National Companies and Securities Commission (Australia), to John Wheeler, Secretary, SEC (July 12, 1985) ("NCSC Comment").

13/ Letter from David C. Mulford, Assistant Secretary for International Affairs, Department of the Treasury, to John Wheeler, Secretary, SEC (June 18, 1985) ("Treasury Comment").

below by the issues and subissues upon which the Release solicited comment.

I. International Trading

A. Generally

1. Should the Commission take action to facilitate international trading?

Commentators recognized that the Commission has an important role to play in the internationalization process. The eight who commented generally on what this role should entail stated that the Commission should refrain from rulemaking that might be premature and permit the international trading markets to develop. The American Stock Exchange ("Amex"), Merrill Lynch Capital Markets ("Merrill"), and the American Bar Association ("ABA") suggested that the Commission could best contribute to the orderly development of global trading by working with market participants and the broker-dealer community to identify possible trouble areas and devise solutions that would not interfere with the evolution of the market. 14/ The National Association of Securities Dealers, Inc. ("NASD") and the ABA stated that the Commission should particularly concentrate on facilitating intermarket trading linkages and international settlement facilities. 15/

The Toronto Stock Exchange ("Toronto"), Amex, and NASD recommended that the Commission undertake efforts to harmonize standards of securities regulation worldwide. 16/ The Amex asserted that the Commission should identify and eliminate unnecessary regulatory burdens that place the U.S. markets at a competitive disadvantage or encourage the growth of competitive markets abroad. 17/ Toronto suggested that multilateral discussions could be conducted under the auspices of the Federation of International Stock Exchanges and the International Association

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14/ Amex Comment, *supra* note 2, at 5-6; Merrill Comment, *supra* note 9, at 3-4; ABA Comment, *supra* note 7, at 2.

15/ NASD Comment, *supra* note 2, at 8-9; ABA Comment, *supra* note 7, at 2.

16/ Toronto Comment, *supra* note 2, at 6; Amex Comment, *supra* note 2, at 6-7, 11; NASD Comment, *supra* note 2, at 9.

17/ Amex Comment, *supra* note 2, at 6-7.

of Securities Commissions and Similar Organizations. 18/

Six of the seven commentators asserted that the Commission should not attempt to establish a structure for global trading markets. These commentators believed the interaction of competitive market forces would lead to the development of the structure necessary for fair and efficient international trading. 19/ ITT Corporation ("ITT"), however, recommended that, once global trading becomes widespread, the Commission should insure that the elements of an international market structure outlined by the Release are implemented. 20/

2. What is the extent to which extended trading opportunities are sought and used by investors at present?

The Securities Industry Association ("SIA") asserted that most activity in multiply-listed stocks occurs on the primary market during regular business hours. 21/ ITT's trading experience with its stock supports that view. ITT stated that virtually all trades in its stock occur in the U.S. on the New York Stock Exchange ("NYSE"), although the stock is listed on twelve major foreign exchanges. 22/ The Australian Associated Stock Exchanges ("AASE"), however, indicated that there is significant overseas activity in its national listings. 23/

The SIA stated that in-house trading by securities firms

18/ Toronto Comment, supra note 2, at 6.

19/ AASE Comment, supra note 2, at 5; NASD Comment, supra note 2, at 9-10; Toronto Comment, supra note 2, at 6; QSC Comment, supra note 12, at 3; ABA Comment, supra note 7, at 2; Merrill Comment, supra note 9, at 3-4.

20/ ITT Comment, supra note 10, at 2.

21/ SIA Comment, supra note 7, at 4.

22/ ITT Comment, supra note 10, at 1.

23/ AASE Comment, supra note 2, at 1-2. The AASE stated that an estimated 30% by value of the trades Australian brokers report take place outside of Australia. Id.

is commonplace. 24/ Merrill and the NASD affirmed that upstairs trading does occur, and said that international broker-dealers frequently trade foreign equities around-the-clock by passing internal order books from time zone to time zone. 25/ U.S. equities, however, are traded around-the-clock less frequently. Merrill indicated that most overseas trading in U.S. equities occurs in Europe, and that some block trading of U.S. equities also takes place in Japan. 26/

> 3. To what extent is the international trading thus far institutional, proprietary, or retail? How does the nature of the trading affect the need for regulatory action?

Commentators stated that market professionals and institutional investors do the vast majority of international trading, and anticipate that these players will continue to dominate the global markets. 27/ Merrill noted that those U.S. retail customers who invest in foreign securities do so through U.S. broker-dealers during normal trading hours, and generally prefer owning ADRs to the foreign stocks themselves. 28/

Commentators concluded that the professional and institutional nature of global trading reduced the need for regulatory actions. Merrill stated that it made establishing a

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24/ SIA Comment, _supra_ note 7, at 3-4.

25/ Merrill Comment, _supra_ note 9, at 1-2; NASD Comment, _supra_ note 2, at 2-3.

26/ Merrill Comment, _supra_ note 9, at 1-2. Because the U.S. markets do not open until mid-afternoon European time, European investors frequently ask U.S. broker-dealers acting as principal to buy or sell blocks of U.S. stocks. Japanese brokers occasionally ask U.S. firms to offer blocks overnight to work during normal Japanese trading hours. _Id_.

27/ AASE Comment, _supra_ note 2, at 6; Amsterdam Comment, _supra_ note 2, at 2; Merrill Comment, _supra_ note 9, at 2, 5; SIA Comment, _supra_ note 7, at 3; Toronto Comment, _supra_ note 2, at 5.

28/ Merrill Comment, _supra_ note 9, at 2.

regulatory framework for the international markets less significant. 29/ Toronto opined that any such framework need not embody as extensive protections for retail investors as there are in the U.S. and Canadian markets. 30/

4. Is the demand for extended trading opportunities primarily based on a desire for liquidity during crisis conditions or for ease in executing routine transactions?

ITT stated that investors currently use extended trading opportunities only in unusual circumstances, and that those trades that occur outside domestic trading hours are generally in the U.S. OTC market and only occasionally overseas. 31/ The Chicago Board of Trade ("CBT"), however, opined that market participants increasingly will need routine access to foreign markets without having to adhere to artificial time constraints. 32/

5. Will extending trading opportunities result in spreading out existing trading over longer hours or will greater trading result?

One securities market and one futures market responded that making international markets more accessible to investors would result in greater trading volume. 33/

B. Market Structure

While commentators agreed that transnational trading would increase, there were differences of opinion over what would constitute the future structure of the international securities markets. The NASD, SIA, and ITT asserted that around-the-clock in-house trading by U.S. based securities firms was more likely

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29/ Merrill Comment, supra note 9, at 5.

30/ Toronto Comment, supra note 2, at 5-6.

31/ ITT Comment, supra note 10, at 1-2.

32/ CBT Comment, supra note 3, at 2.

33/ Toronto Comment, supra note 2, at 4; CBT Comment, supra note 3, at 2.

than a worldwide network of stock exchanges. 34/ The SIA further asserted that forthcoming changes in the London Stock Exchange ("London") would lead to increased trading on an upstairs principal basis, 35/ but Merrill cautioned that the effect of London's expansion of trading in U.S. securities on the present off-board market in listed securities remains to be seen. 36/

Four stock exchanges and a securities regulator, in contrast, argued for the establishment of an interconnected network of stock exchanges. 37/ The Amex indicated that it would continue to forge links with foreign markets. 38/ The Commission de valeurs mobilieres du Quebec ("QSC") and Toronto stated that exchanges should link their automated market information and execution systems to form that network. 39/ The Tokyo Stock Exchange ("Tokyo") and Toronto indicated that simultaneous trading among markets in the same or near time zones was practicable. 40/ The Amsterdam Stock Exchange ("Amsterdam") suggested that multiple simultaneous trading in international equities should take place in the currency of the home market according to the procedures and routines of the home market. 41/

Commentators generally did not express a view on the prospects for coordinated around-the-clock trading between domestic and

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34/ NASD Comment supra note 2, at 8; SIA Comment, supra note 7, at 3; ITT Comment, supra note 10, at 2.

35/ SIA Comment, supra note 7, at 3.

36/ Merrill Comment, supra note 9, at 3.

37/ In fact, Toronto asserted that regulators should not approve intermarket linkages unless those linkages involve exchanges with satisfactory regulatory schemes. Toronto Comment, supra note 3, at 21.

38/ Amex Comment, supra note 2, at 2.

39/ QSC Comment, supra note 12, at 2; Toronto Comment, supra note 2, at 7-8.

40/ Tokyo Comment, supra note 2, at 3; Toronto Comment, supra note 2, at 19-21.

41/ Amsterdam Comment, supra note 2, at 7.

foreign exchanges by arranging for consecutive trading of world-class securities. Toronto did indicate, however, that arrangements for consecutive trading would take longer to achieve than those for simultaneous trading. 42/

1. Consolidated Reporting

a. Should transaction reporting requirements for participants in the U.S. securities markets be expanded? Should NASD member firms be required to report overseas trades in U.S. stocks to a consolidated system on a last sale basis?

National Securities Clearance Corporation ("NSCC") supported expanding current trade reporting requirements to capture and reflect last sale information on trades in U.S. securities occurring overseas. To adequately assess its market exposure and collateralize risks, NSCC stated that it must know the extent of its participants' holdings in particular issues and that the prices it uses to mark its open positions are accurate. 43/

b. Would it be desirable or practical to develop an international consolidated reporting system in stocks traded globally on an active basis?

Commentators generally agreed that the increased dissemination of transaction reporting would facilitate the establishment of global trading markets. The National Association of Pension Funds Ltd. ("NAPF") and the CBT supported making as much market information available as technology currently permits. 44/ Amsterdam similarly stated that direct electronic intermarket data links should be studied as a means of enhancing transaction

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42/ Toronto Comment, supra note 2, at 8-9. Toronto also suggested an alternative market structure in which international securities could be listed only on their home market and foreign nonmember brokers could trade those stocks by direct electronic access to the floor of that exchange. Id. at 7, n.7.

43/ NSCC Comment, supra note 4, at 8.

44/ NAPF Comment, supra note 7, at 2; CBT Comment, supra note 3, at 2.

reporting. 45/ The AASE and QSC recommended that self-regulatory organizations ("SROs") worldwide collect and disseminate accurate and timely transaction reports for internationally traded securities, 46/ and the AASE suggested that this concerted action could lead to the development of an international consolidated system if market demand was sufficient. 47/ ITT stressed that increased in-house trading would make developing an international consolidated reporting system more important and opined that, without such a system, only those market participants with access to specialized segments of the broker-dealer community would be aware of trading outside normal hours. 48/

Two commentators highlighted the practical difficulties of developing a consolidated reporting system for globally traded stocks. Merrill stated that a consolidated reporting requirement would be impractical unless other markets developed automated systems and transaction reporting tapes, and a more formal global market with greater U.S. investor participation evolved. 49/ Toronto asserted that wide differences in trading systems and trade reporting among world markets made prospects for a consolidated system remote, and the need for currency conversion facilities posed additional obstacles. 50/

45/ Amsterdam Comment, *supra* note 2, at 4. For the immediate future, Amsterdam endorsed using the infrastructure that commercial vendors provide. *Id.*

46/ AASE Comment *supra* note 2, at 4; QSC Comment, *supra* note 12, at 4.

47/ AASE Comment, *supra* note 2, at 4.

48/ ITT Comment, *supra* note 10, at 2.

49/ Merrill Comment, *supra* note 9, at 2-3.

50/ Toronto Comment, *supra* note 2, at 13-16, 14 n.14. Toronto indicated that developing currency conversion facilities is complex even where the securities markets are as similar as those in the U.S. and Canada. Moreover, Toronto stated that the conversion facilities developed for its linkages with the American and Midwest Stock Exchanges will disseminate converted prices that inevitably differ from the standard eighth point price intervals of the North American exchanges' computer software. *Id.* at 15-16.

Two commentators questioned the desirability of an international consolidated tape. The SIA asserted that the current paucity of simultaneous or coordinated exchange trading coupled with the efficiency of existing international trading mechanisms made a tape unnecessary. 51/ The NASD claimed that any attempt to foster the development of an international consolidated reporting system might appear to be an attempt to force the integration of foreign and domestic markets. 52/

c. Could uniform reporting requirements for securities traded internationally be devised?

Tokyo stated that harmonizing the information systems of various marketplaces may become necessary as cross-border equity trading grows. Tokyo recognized that harmonization would be difficult because of differing trading and reporting systems, systems, but recommended that the effort begin gradually with securities listed in multiple international markets. 53/ The CBT also endorsed harmonization. 54/ Amsterdam suggested that the problem of different reporting requirements could be obviated if each market trading a particular security were to utilize the reporting requirements of the security's home market and country. 55/

d. What level of international trading activity would be necessary before the cost of a consolidated system would be justified? As an interim measure, would it be feasible to have a system that disseminates different kinds of information from various markets?

While commentators generally agreed that more international trading would be necessary to justify the cost of a tape,

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51/ SIA Comment, _supra_ note 7, at 4.

52/ NASD Comment, _supra_ note 2, at 8.

53/ Tokyo Comment, _supra_ note 2, at 4.

54/ CBT Comment, _supra_ note 3, at 2-3.

55/ Amsterdam Comment, _supra_ note 2, at 3. Amsterdam also recommended that trading and, thus, reporting also be in the currency of the home market and country. _Id._ at 6. _See also infra_ text accompanying note 69.

none provided specific information on what the requisite volume might be. With respect to a possible interim system with nonuniform reporting, Toronto stated that disseminating real-time last sale information for the U.S. and Canadian markets together with nonreconciled periodic volume data from markets without last sale reporting would confuse investors. 56/

2. Consolidated Quotations

a. Is or will a consolidated quotation system be needed internationally?

The eight commentators who responded reiterated the views they expressed with respect to the desirability of an international consolidated reporting system. The NAPF, CBT, AASE, QSE, and Amsterdam stressed the importance of widespread dissemination of international quotation information. 57/ In particular, Amsterdam stated that investors would not be able to determine to which market to direct orders in international listings without knowing bids and offers worldwide. 58/

Merrill and Toronto highlighted the practical difficulties of developing an international consolidated quotation system. 59/ Merrill and the SIA also questioned the desirability of developing such a system at this time. Merrill stated that individual investors presently do not trade directly in foreign markets, and consolidated quotes primarily would benefit a small group of market professionals who already have access to that data through their own sophisticated communications systems. 60/ The NASD generally questioned the desirability of a consolidated system. 61/

56/ Toronto Comment, supra note 2, at 14 n.14.

57/ NAPF Comment, supra note 7, at 2; CBT Comment, supra note 3, at 2; AASE Comment, supra note 2, at 4; Amsterdam Comment, supra note 2, at 4.

58/ Amsterdam Comment, supra note 2, at 4.

59/ Merrill Comment, supra note 9, at 2; Toronto Comment, supra note 2, at 15-16.

60/ Merrill Comment, supra note 9, at 2-3; SIA Comment, supra note 7, at 4.

61/ NASD Comment, supra note 2, at 8.

b. How active would simultaneous trading have to be for consolidated quotations to be justified?

While commentators generally agreed that more international trading would be necessary, none provided specific projections.

c. Is the market information presently available in the international markets for debt sufficient to ensure efficient pricing?

The NAPF expressed serious concerns over the adequacy of market information currently available in the international bond markets. 62/

3. Intermarket Linkages

a. Would pricing disparities be likely to develop from multiple international trading, and if so, would arbitrage activity bring the markets into line? If not, should there be mechanisms such as intermarket linkages to permit orders to be routed to the market with the best price?

Merrill, the SIA, the AASE, and the CBT stated that pricing disparities inevitably would result from the same security trading simultaneously on multiple international markets, but that arbitrage activity likely would eliminate or substantially reduce price differences between markets. 63/ Nevertheless, Merrill, the SIA, and the AASE supported the eventual development of intermarket linkages if necessitated by commercial considerations rather than regulatory initiatives. 64/ In fact, Merrill asserted that meaningful international linkages would be a prerequisite for an effectively functioning global marketplace, for relying on arbitrage to correct pricing disparities was somewhat inefficient. 65/

62/ NAPF Comment, supra note 7, at 2.

63/ Merrill Comment, supra note 9, at 2; SIA Comment, supra note 7, at 4; AASE Comment, supra note 2, at 4; CBT Comment, supra note 3, at 3.

64/ Merrill Comment, supra note 9, at 2-3; SIA Comment, supra note 7 at 4-5; AASE Comment, supra note 2, at 4.

65/ Merrill Comment, supra note 9, at 2-3. Merrill cautioned

(footnote continued)

The Amex commented that arbitrageurs play an important role in keeping prices in dually listed Amex and Toronto issues consistent, and stated that significant price disparities between the U.S. and Canadian markets are relatively rare. The Amex noted, however, that orders from one country generally do not benefit from the better price in another unless the order size and price differential are large enough to cover the arbitrageur's transactional costs and allow some profit. The Amex asserted that intermarket linkages would enhance and to some degree replace arbitrage activity by making it possible for orders to get the best price available in either the U.S. or Canada after a small transaction fee. 66/

Toronto and Amsterdam supported the establishment of electronic trading links between markets as a matter of course. Both agreed that linkages would enhance the quality of international trading. 67/ In this connection, Toronto asserted that linkages would enhance depth and liquidity, lead to increased automation, and serve as the impetus for harmonizing securities laws, trading rules, and settlement procedures. 68/ Amsterdam contended that, if a linked international trading network were to be developed, it should be based on what it called the "home-market" system. Under that system, markets around the globe trading a particular security would do so in the home-market's currency based on home-market routines and procedures, thus insuring the comparability of quotes and prices from all markets. 69/

Tokyo, however, stated that it was not prepared at this time to enter into linkages with markets in other countries.

(footnote continued)

that convincing international trading partners of the need for intermarket linkages would be extremely difficult, and asserted that such a network could not be established unless all groups of market participants had an incentive to participate. Id.

66/ Amex Comment, *supra* note 2, at 4-5.

67/ Toronto Comment, *supra* note 2, at 7-9; Amsterdam Comment, *supra* note 2, at 4.

68/ Toronto Comment, *supra* note 2, at 7-9.

69/ Amsterdam Comment, *supra* note 2, at 6.

Tokyo asserted that Japan's location and time zone presently made simultaneous trading in world class securities on a U.K.-U.S.-Japan nexus impracticable. 70/

The NASD viewed intermarket linkages from a different perspective. The NASD asserted that firms would develop their own linkages as part of their in-house trading capabilities, and a global network for automatically executing transactions would evolve once firms found it economical to stop doing business by telephone. 71/

b. Would it be feasible or desirable to develop links between foreign over-the-counter trading of U.S. securities and trading in the U.S. securities markets?

Toronto indicated that the Commission should approve only intermarket linkages involving exchanges. Toronto argued that exchange markets, unlike the upstairs interdealer market, have the market surveillance facilities and regulatory framework necessary to safeguard investor protection. 72/

c. Would intermarket linkages developed likely involve exclusive agreements between a national securities exchange and a foreign market, and if so, would that exclusivity impose a burden on competition inconsistent with the provisions of the Exchange Act?

Amsterdam asserted that intermarket linkages should not be exclusive, and that markets should be prepared to link with more than one other market. 73/

B. Securities Processing

1. Are international clearing links necessary for the further expansion of international trading markets?

70/ Tokyo Comment, supra note 2, at 6.

71/ NASD Comment, supra note 2, at 8.

72/ Toronto Comment, supra note 2, at 20-21.

73/ Amsterdam Comment, supra note 2, at 4.

Commentators agreed that efficient, safe, and accurate comparison, clearance, and settlement systems were necessary for the growth of international trading, and stated that additional and improved links between central clearing and depository organizations would be desirable. 74/ Indeed, NSCC emphasized that intermarket linkages could not function effectively without companion securities processing mechanisms. 75/ International Commodities Clearing House Limited ("ICCH") and four other commentators stated that any such linkages should be reciprocal two-way interfaces in which the foreign and U.S. clearing agencies are members of each other. 76/ Tokyo noted that it would continue to develop links with foreign depositories and clearing agencies when necessary for efficient custodial services for Japanese stocks listed on foreign exchanges or foreign stocks listed on Tokyo. 77/ Commentators generally noted, however, that a major practical obstacle to the developmen of international clearing linkages was resolving currency conversion problems. 78/ Only the CBT questioned the necessity of establishing formal linkages. 79/

2. Should future clearing links be developed on an incremental basis or should concerned parties consider creating a centralized, internationally-

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74/ See, e.g., ISSA Comment, supra note 11, at 2.

75/ NSCC Comment, supra note 4, at 2-3.

76/ ICCH Comment, supra note 4, at 2-5. See also CDS Comment, supra note 4, at 13; ISSA Comment, supra note 11, at 3; MCC/MSTC Comment, supra note 4, at 3-4; QSC Comment, supra note 12, at 3-4.

77/ Tokyo Comment, supra note 2, at 8.

78/ See, e.g., CDS Comment, supra note 4, at 18. The CDS stated that trades should be settled in the currency in which the trade took place for international clearing linkages to operate most efficiently. Id. Amsterdam's suggested "home-market" system would achieve that result; securities would b traded in markets around the globe in the home-market's currency, thus obviating the need for currency conversion facilities. See Amsterdam Comment, supra note 2, at 6. See also supra text accompanying note 69.

79/ CBT Comment, supra note 3, at 3.

governed clearing or depository entity for international trades?

While the International Symposium of Securities Administrators ("ISSA"), Toronto, and the SIA stated that the creation of a central international clearing or depository entity might be desirable, they, together with five other commentators, concluded that the incremental development of links between existing institutions would be both preferable and practicable. 80/ The ISSA asserted that establishing a special global securities processor would be impracticable because private investors, institutional investors, and large banks and broker-dealers have differing resources and requirements. 81/ The Midwest Clearing Corporation and Midwest Securities Trust Company ("MCC/MSTC") indicated that there would be problems in the ownership, financing, and operational control of a single international entity, and opined that it would not be welcomed by existing clearing agencies. 82/

3. Should the Commission develop specific standards to determine whether foreign clearing agencies should be permitted to participate in a link with a U.S. clearing agency or be required to register in the U.S. under Section 17A of the Exchange Act?

NSCC and MCC/MSTC argued that it would be premature to develop eligibility standards with which all clearing agencies and marketplaces would have to comply, although MCC/MSTC

80/ ISSA Comment, supra note 11, at 2; Toronto Comment, supra note 2, at 16 n.17; SIA Comment, supra note 7, at 6. See also Amsterdam Comment, supra note 2, at 4-5; CDS Comment, supra note 4, at 27; Merrill Comment, supra note 9, at 4; MCC/MSTC Comment, supra note 4, at 2; OSC Comment, supra note 12, at 3-4.

81/ ISSA Comment, supra note 11 at 2. The ISSA stated that, while large entities with branches or subsidiaries overseas could become direct members of a foreign central clearing and depository entity, private and institutional investors might find it better to be served through domestic custodians. Id.

82/ MCC/MSTC Comment, supra note 4, at 2.

allowed that such standards might be workable if made sufficiently flexible to encompass the wide variety of foreign clearing agencies. Both endorsed the current staff practice of determining foreign clearing agency eligibility for international linkage participation through no-action letters. 83/ While NSCC preferred the no-action approach, it suggested as an alternative guidelines similar to those the Division of Market Regulation uses for determining whether to register a U.S. clearing agency. NSCC stated that, after additional experience is gained with international clearing arrangements, guidelines would enable clearing agencies to rely upon examples in designing linkages and expect that their actions would receive Commission approval. 84/

Two commentators emphasized the usefulness of specific eligibility standards. ICCH stated that, to facilitate the development of reciprocal clearing interfaces, the Commission should publish guidelines on how proposed amendments to U.S. clearing agency rules designed to implement such a linkage would be analyzed under Section 19 of the Exchange Act. 85/ The AASE recommended that countries interested in international clearing linkages should establish common standards for linkage participation, and noted that these standards would provide Australian clearing facilities with guidance on how best to upgrade their systems. 86/

Merrill indicated that it was too early to decide whether foreign clearing agencies entering into links should be required

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83/ NSCC Comment, supra note 4, at 5-7; MCC/MSTC Comment, supra note 4, at 3. NSCC nevertheless recognized that the no-action approach has certain weaknesses. For example, parties tend to rely on existing letters and do not seek the advice of the Commission staff at a sufficiently early point in the linkage developmental process. NSCC recommended that, if the Commission continues to follow a no-action approach, the Commission should make clear that links would not be approved without prior Commission confirmation of the applicability of prior no-action positions. NSCC Comment, supra note 4, at 6-7.

84/ NSCC Comment, supra note 4, at 5.

85/ ICCH Comment, supra note 4, at 5-6.

86/ AASE Comment, supra note 2, at 6-7.

to register in the U.S. under § 17A of the Exchange Act. 87/ The ISSA, CDS, and MCC/MSTC, however, opposed requiring § 17A registration. The ISSA and CDS asserted that the central depository of one country should not have to register with or report to regulatory authorities in another country as a condition of participating in a linkage with a clearing agency in that country. 88/ MCC/MSTC argued that foreign clearing agencies would find § 17A registration burdensome and, therefore, would not establish new linkages with U.S. securities processors. 89/

4. Should U.S. clearing agencies develop special admission standards for foreign clearing agencies that seek to become members of U.S. clearing agencies?

NSCC and CDS commented that foreign clearing agencies should become members of U.S. clearing agencies based on membership standards comparable to those applicable to U.S. participants. NSCC reasoned that foreign clearing agencies are too diverse for the development of special uniform membership criteria to be practicable, and the existence of such criteria could hamper the structure of potential linkage relationships. As a substitute for uniform standards, NSCC suggested that a due diligence examination be required of foreign clearing agencies proposed to be admitted to membership. 90/ CDS stated that separate membership standards were unnecessary because the foreign clearing agency would be liable for the accounts of its members. 91/

5. How can safeguarding of securities and funds be insured when one or more U.S. clearing agencies involved in future two-way interfaces are exposed to regulatory requirements and financial risks that could be very different from those encountered in this country?

CDS asserted that its participation in U.S. clearing agencies

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87/ Merrill Comment, *supra* note 9, at 4.

88/ ISSA Comment, *supra* note 4, at 3; CDS Comment, *supra* note 4, at 24-25.

89/ MSCC/MSTC Comment, *supra* note 4, at 2-3.

90/ NSCC Comment, *supra* note 4, at 7.

91/ CDS Comment, *supra* note 4, at 25-26.

does not expose the U.S. national clearance and settlement system to financial risks of a degree or kind different from those created by the acceptance of a U.S. participant in a U.S. clearing agency. CDS submitted, therefore, that the safeguarding mechanisms applicable to foreign clearing agencies becoming participants in foreign counterparts should be similar to the safeguards established by that clearing agency for its domestic participants, and added that the only additional requirement should be that the foreign clearing agency agree to abide by the laws and submit to the courts of the jurisdiction in which the counterpart clearing agency is located. 92/

Merrill, in contrast, suggested that establishing a separate clearing entity to link the U.S. national clearance and settlement system with foreign clearance and settlement systems might be prudent. Merrill stated that such a separate entity might help limit the financial exposure of the U.S. broker-dealer community. 9
The ISSA also said that the separate clearing entity concept deserves special attention. 94/

C. Barriers to Entry

1. What effect on international trading do limitations on broker-dealer access to foreign markets have and what actions, if any, should be taken to reduce these barriers?

The Department of the Treasury ("Treasury") stated that it is working through the Organization for Economic Cooperation and Development ("OECD") to promote the rights of U.S. banks and securities firms overseas. 95/ The SIA agreed that U.S. firms should have the opportunity to operate abroad without competitive restrictions, as foreign firms do in the U.S. The SIA noted that, while progress has been made, significant limitations on access exist in a number of important markets. The SIA cautioned, however, that it may be premature for the Commission to take

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92/ CDS Comment, _supra_ note 4, at 26-27.

93/ Merrill Comment, _supra_ note 9, at 4.

94/ ISSA Comment, _supra_ note 11, at 2.

95/ Treasury Comment, _supra_ note 13, at 1.

action to reduce barriers because access limitations may fall as a result of economic forces. 96/

> 2. What barriers, if any, result from the broker-dealer regulation of various countries? Does this regulation significantly limit broker-dealers from entering foreign markets?

The NASD recommended that the Commission review the U.S. domestic securities laws applicable to international transactions, identify which constitute barriers to entry, and initiate steps to remove those barriers. 97/ The CBT proposed that the Departments of State or Commerce, with assistance from affected regulatory agencies, work to reduce and harmonize market regulation worldwide in order to facilitate market entry and enhance market performance. 98/

Algemene Bank Nederland N.V. ("Algemene") asserted that the Glass-Steagall Act is a barrier to universal bank entry into the U.S. securities markets. Algemene stated that, because of its U.S. commercial banking activities, it must form a broker-dealer subsidiary to engage in a securities business in the U.S. 99/

II. Multinational Distributions of Securities

> A. To what extent could the investor protections afforded by the Exchange Act be maintained and coordinated with those of other countries, particularly in the context of the distribution of securities on a multinational basis?

Tokyo stated that exchange regulations and the Japanese securities laws prohibit manipulative trading even in the case of a cross-national distribution. 100/ Amsterdam and the

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96/ SIA Comment, _supra_ note 7, at 7-9.

97/ NASD Comment, _supra_ note 2, at 9.

98/ CBT Comment, _supra_ note 3, at 3.

99/ Algemene Comment, _supra_ note 6, at 1.

100/ Tokyo Comment, _supra_ note 2, at 9.

AASE agreed that securities regulators and marketplaces should insure that investors are protected, and that the evolution of the global market should not be constrained by the lack of harmonization. The AASE asserted, however, that certain standards would be unacceptable in Australia. 101/

B. To what extent could the Commission's prior approach to international stabilization be continued or refined?

The ABA endorsed the Commission's current case-by-case approach to interpreting Rules 10b-6 and 10b-7 under the Exchange Act, stating that no single legislative or rulemaking approach would be suitable for dealing with all the hypothetical issues that could arise as a result of simultaneous distributions. The ABA noted, however, that the Commission might be able to provide more general guidance as multinational activity increases and similar situations recur. The ABA said that guidelines on the interaction of Rule 10b-6 and foreign securities distributions and market practices would reduce uncertainty and facilitate internationalization, and suggested that guidelines could be general indications of: (1) specific Commission concerns where Rule 10b-6 is technically incompatible with foreign rules and practices; (2) situations in which the staff would be receptive to granting a no-action position or an exemptive order on the basis that, while there might be technical violations of Rule 10b-6, the intent and policy behind the rule would not be violated; and (3) elements of factual situations which would cause the staff to be inclined not to take a no-action position or issue an exemptive order. 102/

The SIA agreed that the Commission's case-by-case approach has balanced investor protection with the legitimate interests of issuers and underwriters. The SIA recommended, however, that the Commission consider liberalizing amendments to Rules 10b-6 and 10b-7 for offerings outside the U.S. because rules designed for the U.S. markets often are inapplicable to foreign markets. 103/

101/ Amsterdam Comment, *supra* note 2, at 5; AASE Comment, *supra* note 2, at 5-6.

102/ ABA Comment, *supra* note 7, at 4-5.

103/ SIA Comment, *supra* note 7, at 10-11.

III. International Enforcement Problems

A. What mechanisms could be developed to monitor trading in international markets?

The Amex, Toronto, Amsterdam, and the CBT stated that markets should share market information and cooperate on international market surveillance. 104/ Amex suggested that this might be accomplished by either formal agreement between linked foreign and domestic markets or the creation of an international inter-market surveillance group. 105/ Tokyo asserted that investors in multinationally listed securities were protected at least for the time being by the surveillance mechanisms of individual markets, but recognized that stock exchanges will have to cooperate more closely in the future by exchanging information on trading in multinational listings. 106/

B. What measures could be taken to address the possible erosion of trading halts that could affect the integrity of the U.S. securities markets?

Toronto, Tokyo, and Amsterdam asserted that markets should act in concert to halt trading in multinational listings in appropriate circumstances. 107/ Toronto suggested that inconsistent practices involving trading halts were a barrier to the effective integration of the North American markets, and that upon the occurrence of material corporate developments every market trading an interlisted security should halt trading in that issue for sufficient time to place market participants everywhere on an equal footing. Asserting that markets should not seek a competitive advantage by recommencing trading earlier, Toronto recommended that the Commission and Canadian securities regulators should adopt rules requiring that all trading (including that in the third market) be

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104/ Amex Comment, _supra_ note 2, at 8-9; Toronto Comment, _supra_ note 2, at 11-13, 18; Amsterdam Comment, _supra_ note 2, at 5,7; CBT Comment, _supra_ note 3, at 3.

105/ Amex Comment, _supra_ note 2, at 8.

106/ Tokyo Comment, _supra_ note 2, at 10.

107/ Toronto Comment, _supra_ note 2, at 18-19; Tokyo Comment, _supra_ note 2, at 10; Amsterdam Comment, _supra_ note 2, at 5.

halted until the primary North American market determines that trading may recommence. 108/

C. Would it be practicable to reach bilateral or multilateral agreements on securities law enforcement, possibly through the aegis of a coordinating body of national regulatory entities?

The Treasury, Amex, ABA, SIA, and National Companies and Securities Commission of Austrialia ("NCSC") endorsed working for mutually agreeable bilateral or multilateral accords on international securities law enforcement. 109/ In fact, the NCSC stated its willingness to discuss with the Commission the terms of a bilateral agreement to formalize their existing informal arrangements. 110/ The QSC, however, indicated that formal bilateral or multilateral enforcement agreements might not be necessar if assistance were limited to securities regulators instead of governments. 111/

The Treasury, ABA, and SIA emphasized that negotiations involving international regulatory cooperation should be conducted under the auspices of existing international organizations where the U.S. government already has work underway. The Treasury recommended the OECD as a forum, while the ABA recommended the Bank for International Settlements. 112/

IV. Other Issues

108/ Toronto Comment, *supra* note 2, at 18-19.

109/ Treasury Comment, *supra* note 13, at 2; Amex Comment, *supra* note 2, at 10-11; ABA Comment, *supra* note 7, at 2-4; SIA Comment, *supra* note 7, at 9-10; NCSC Comment, *supra* note 12, at 2. Amex cautioned that accords such as these only would be successful if securities laws violations in one jurisdiction were considered violations in other jurisdictions, and suggested that the principal financial centers develop uniform standards in key areas. Amex Comment, *supra* note 2, at 10-11.

110/ NCSC Comment, *supra* note 12, at 2.

111/ QSC Comment, *supra* note 12, at 5.

112/ Treasury Comment, *supra* note 13, at 2; ABA Comment, *supra* note 7, at 3-4; SIA Comment, *supra* note 7, at 10.

A. Rights Offerings

Three international pension fund managers, 113/ a custodial bank, 114/ and a law firm 115/ expressed concern that U.S. investors in foreign securities are excluded from participating in the unregistered rights offerings which foreign issuers frequently use as a substitute for dividends, and suggested that the Commission create a safeharbor permitting the offering of these unregistered rights to U.S. institutional investors without violating the Securities Act of 1933.

B. Short Sales

The SIA urged the Commission to study the applicability of Rule 10a-1 under the Exchange Act to transactions executed abroad. The SIA asserted that, given the absence of continuous transaction reporting in foreign markets and the difficulty of determining last sale prices for transactions executed abroad when U.S. exchange markets are closed, it is unclear that the short sale rule was ever intended to apply to overseas transactions. 116/

C. One Share-One Vote

The NAPF stated that it has sought to limit the issuance of nonvoting shares in the U.K., and expressed concern over NYSE proposals to permit the continued listing of companies with dual capitalization. The NAPF warned that U.K. companies unable to issue nonvoting securities in the U.K. could use the international markets to do so through the NYSE, thereby diminishing the rights of U.K. shareholders. 117/

113/ Baring Comment, *supra* note 5, at 1; BT Comment, *supra* note 5, at 1-2; Mellon-Pictet Comment, *supra* note 5, at 1.

114/ Bankers Trust Comment, *supra* note 6, at 1-2.

115/ M&F Comment, *supra* note 8, at 1-3. Morrison & Foerster commented on behalf of G.T. Capital Management, Inc.

116/ SIA Comment, *supra* note 7, at 10-11. Although the New York Stock Exchange ("NYSE") did not discuss this topic in its comment letter, the NYSE is studying a proposal formulated in response to the growth of international trading that would narrow the scope of its short sale rule. *See* NYSE Comment, *supra* note 2, at 1.

117/ NAPF Comment, *supra* note 7, at 1-2.

D. Tender Offer Disclosure

The Panel on Take-overs and Mergers of the London Stock Exchange stated its interest in insuring that certain share transactions during takeovers would continue to be disclosed on a timely basis as the international markets develop. 118/

E. Investment Company Matters

The Investment Company Institute ("ICI") stated that trading outside normal NYSE trading hours might raise issues concerning the pricing of fund shares for sale and redemption, and the purchase of the securities of certain foreign issuers, such as diversified banking institutions, might raise concerns under Section 12 of the Investment Company Act. The ICI also recommended seeking bilateral or multilateral agreements for the reciprocal sale of American funds in Europe and European funds in the U.S. 119/

118/ LSE Comment, *supra* note 2, at 1.

119/ ICI Comment, *supra* note 7, at 1-2.

C H A P T E R   V

A P P E N D I X   B

SUMMARY OF

INTERNATIONALIZATION ROUNDTABLE

February 17, 1987

Prepared by

THE DIVISION OF MARKET REGULATION

August 1, 1987

Internationalization Roundtable

Executive Summary

The morning Roundtable discussion centered on secondary market issues. The panel focused specifically on trading mechanisms, clearance and settlement, regulatory adaptations to accommodate the internationalization of the markets, regulatory oversight and barriers to entry.

Although there was general agreement on the inevitability of the convergence of the world's capital markets, participants did not agree on the form these multinational markets ultimately would take. Several participants believed that upstairs markets would predominate and would maximize the capital efficiency of the global market. Others believed that electronically linked exchange markets would prove to be preferable to upstairs markets. There was general agreement, however, that, regardless of the future structure, issuers' home countries would continue to be their primary source of liquidity.

The panel also generally agreed that the single largest challenge facing the industry is the development of efficient and safe clearance and settlement facilities. Participants were encouraged by the development of linkages among the world's clearance and settlement systems but also noted that the problem of widely differing settlement cycles and systems capabilities still needs to be addressed.

The self-regulatory organizations ("SROs") represented on the panel stressed the importance of developing effective mechanisms for the exchange of surveillance and enforcement information. It was stressed that such mechanisms will be increasingly important, for example, to U.S. SROs in examining their members that have foreign affiliates. Currently, their ability to examine these foreign affiliates is extremely limited.

The Commission also asked the participants to discuss whether regulatory adaptations would be necessary to facilitate the process of internationalization (e.g., modifications to the short-sale rule or off-board trading restrictions). Although participants applauded the Commission and the SROs' willingness to re-examine their regulatory structures, they also cautioned against a "race to the bottom." Participants stressed that U.S. markets are perceived as fair and equitable and that investors generally believe that such markets provide significant benefits.

The final topic was the issue of whether foreign firms still face barriers to entry to domestic markets. Participants, commenting as U.S. firms seeking entry to other markets and as foreign firms seeking entry to U.S. markets, agreed that substantial progress has been made in the breaking down of legal barriers to entry. They also agreed that significant "cultural" barriers, particularly in terms of understanding the foreign jurisdiction's regulatory structure and breaking into markets, still exist. One example cited was gaining access to underwriting syndicates.

The afternoon Roundtable discussion covered primary offerin in the international context and foreign broker-dealer activity in the United States. The participants discussed the applicatio of Securities Act requirements to offshore primary offerings by United States firms. The participants agreed that there should be a territorial approach to the application of the Securities Act. They also agreed that the Securities Act imposes certain artificial impediments and costs on the operation of the markets In addition, there was a consensus that although some restrictio on "flowback" -- the entry back into the United States of the unregistered securities of a domestic issuer -- is necessary to prevent evasion of the Securities Act, the present approach must be simplified.

The panel discussed the benefits of creating a "free trade zone" for the trading by institutions of securities that would be exempt from registration. The participants recognized that the free trade zone concept is thus far undefined and unclear and discussed possible limitations on the eligible issuers of securities. Also, the discussions focused on the ability of foreign firms to conduct public securities offerings in the United States. The panelists commented on the advantages of using a reciprocal prospectus approach under which offering documents accepted in the home jurisdiction could be used in the United States. Some participants noted their skepticism with the reciprocal prospectus concept and noted that it should be limited at first to debt, and possibly equity offerings of certain world-class issuers.

The panelists then discussed efforts by foreign broker-dealers to enter United States markets and the circumstances under which registration should be required. The participants had differing views as to whether foreign broker-dealers, who, for example, only disseminated research or dealt only with registered broker-dealers in the United States should be required to become registered broker-dealers in the United States.

Finally, there was a brief presentation by the manager of an international fund who indicated that successful performance comes from selection of markets rather than particular securities. In this regard, the fund manager indicated that traditional disclosure concerning issuers and their securities was less important than knowledge of foreign markets and trends.

Summary of Proceedings

On February 17, 1987, the Commission held a Roundtable on Internationalization, a public meeting at which numerous experts discussed various aspects of the internationalization of the securities markets. The list of participants and the specific issues discussed are contained in the attached Briefing Memorandum (Attachment A), that was distributed to Commissioners and participants before the meeting and is publicly available. This document summarizes the Roundtable discussion and the written remarks submitted by some participants. The written remarks are attached as Attachment B.

The Chairman began the proceedings by welcoming the participants and stating that the internationalization of the securities markets offers great benefits and challenges, with the most important areas of concern being the balance of trade

and payments, the international monetary system, restructuring by less developed countries, and off-balance sheet bank-guaranteed swaps and other credits. The Chairman added that the areas of specific interest to the Commission include international surveillance and enforcement, clearance and settlement, and disclosure systems and practices.

After each participant identified himself, the Chairman introduced the first topic, which was international secondary market trading mechanisms.

Messrs. Unruh (Toronto Stock Exchange), Fernandez (Nomura Securities) and Meyjes (Citicorp Investment Bank) presented prepared remarks. Mr. Unruh stated that the first question is the role of dealer markets in the developing global market structure. Mr. Unruh indicated that upstairs markets are preferable to floor markets. Mr. Unruh believed that the real question was which of the two principal different types of markets would predominate: Markets where prices primarily are determined by the interaction of orders represented on an agency basis by broker-dealers with centralized limit order protection; or markets where prices primarily are determined by the interaction of dealers with other dealers and customers based upon the dealers quotations. Mr. Unruh indicated that dealer markets linked by consolidated quotation dissemination and price reporting systems could be used internationally with a core group of international stocks. Mr. Unruh recognized the structural problems with that approach, and emphasized the need of dealer, quotation-driven markets for larger amounts of

capital. Mr. Unruh stated, however, that quotation-linked markets could become unstable. Mr. Birnbaum (New York Stock Exchange) disagreed with Mr. Unruh and stated that exchange markets are preferable to upstairs markets.

In his written remarks, Mr. Unruh elaborated on his ideas, stating that "book-based" market linkages are preferable and would maximize the capital efficiency of the global market for the stocks included. Such a system would involve bilateral agreements to route orders to the home market and would require two thirds of the capital required by the specialist system.

Mr. Fernandez stated that Nomura engages in 24-hour trading and is interested in various international linkages and other experiments the exchanges and others are conducting. The biggest problem from Nomura's point of view is the lack of clarity in overseas trading mechanisms, such as how to mark tickets and how to determine the time of trade for certain transnational trades. Nomura indicated that generally it is unsure whether firms have the burden to turn away a deal until they are told it is appropriate and, if so, whether regulators should beef up their staff to answer these kinds of questions. The alternative, Mr. Fernandez believed, is chasing transactions offshore.

Mr. Meyjes stated that he believes there is no question about the nature of the convergence of marketplaces, indicating for instance that about 40% of transactions in French securities, and as many as 90% of transactions in Swedish securities, occur in London. In all, about 16% of stock exchange volume worldwide involves counterparts not located in the same country.

In the opinion of Mr. Meyjes, the principal constraint on globalization of equity markets is that liquidity outside a security's home country is hard to achieve. He believes that, as a practical matter, the home market would continue to determine volume, prices and costs of funding positions. Mr. Meyjes also indicated that the SEC should be particularly interested in settlement problems and concluded that internationalization of the markets would continue but the industry and regulators both must accept that there would be setbacks along the way.

Mr. Davin (NASD) agreed with Mr. Meyjes that liquidity is a major concern and indicated that permitting U.S. firms to sell foreign options to U.S. citizens would help in this regard. Mr. Davin also agreed that delivery problems are the single largest impediment to global trading. Chairman Shad also noted that settlement cycles vary among markets and fail rates are as high as 40% in some markets.

In response to a question from Commissioner Cox, Mr. Davin stated that one way in which the Commission could facilitate international linkages would be to approve the NASDAQ/SEAQ 1/ linkage on a full pilot basis for two years, although Mr. Davin noted that the NASDAQ/SEAQ linkage currently is of minimal value to professionals who have a complete array of information sources. He stated that he believed that the linkage could be of value, however, to institutional investors. Mr. Davin added

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1/ The "SEAQ" system is the Stock Exchange Automated Quotation system of the ISE implemented on October 27, 1986, as part of Big Bang. It is a quotation collection system similar to NASDAQ.

that the linkage may have contributed somewhat to the growth in volume in U.K. American Depositary Receipts ("ADRs") and again urged Commission approval of a two-year pilot that would provide the Commission more data to assess the experiment. Mr. Knight [The International Stock Exchange of the U.K. and the Republic of Ireland, Ltd. ("ISE")] agreed with Mr. Davin's remarks.

Chairman Shad then introduced the next topic, international sharing of surveillance and other information. Mr. Leibler [American Stock Exchange ("Amex")] and Mr. Oyens (Amsterdam Stock Exchange) were the speakers on this topic.

Mr. Leibler stated that Amex's experience had been that foreign markets are willing to share most routine information needed for market surveillance but were concerned about disclosing customers' identities. Countries such as Canada, however, which share a common legal and cultural background with the U.S., are less reluctant to agree to share such information, as evidenced by the Amex-Toronto Stock Exchange information sharing agreement and the Ontario Securities Commission and Commission correspondence on Canada's blocking statute.

Other jurisdictions, particularly those with legal restrictions on disclosure of confidential customer information, are more reluctant to negotiate agreements. The European Options Exchange ("EOE") recently reached an information sharing agreement with Amex, however, by changing its by-laws to require its members to agree to allow EOE to share customer information with Amex.

Mr. Leibler added that the Commission should continue to encourage the development of common standards of conduct, for example, that insider trading is improper. Further, Mr. Leibler emphasized that the Commission should continue to negotiate agreements with foreign authorities. Mr. Leibler also stated that U.S. markets should continue to establish trading linkage agreements with foreign markets that provide for information sharing. He concluded by recommending that the Commission encourage foreign participation in intermarket surveillance groups and the formation of international intermarket surveillance groups.

Mr. Oyens agreed with Mr. Leibler's remarks on information sharing and added that regulators should not seek one harmonized global regulatory system. Rather, exchanges should create generally accepted principles of trading and regulators should then coordinate and cooperate on enforcement.

Commissioner Grundfest agreed with Mr. Oyens, stating that the long-term goal is structuring a cooperative environment in which each trading partner recognizes the legitimate interests of other trading partners in preventing the use of their domestic markets for the evasion of their trading partner's domestic laws, while each partner seeks not to impose its own unique views on its soverign trading partners.

Chairman Shad then introduced the next topic: international market information. Mr. Knight and Mr. Davin were the commentator

on this topic. Mr. Knight stated that his exchange had reorganized itself under the new securities laws in the U.K. As part of that reorganization it is developing a regulated foreign equity market which will enable trading in widely held, liquid non-U.K. securities and that will have, in time, trade and volume reporting.

Mr. Davin took this opportunity to repeat that Commission approval of the NASDAQ/SEAQ quotation link on a two-year pilot basis would be desirable. Mr. Davin then indicated that the benefits of internationalization were profound, including greater liquidity and broader dissemination of market information from major markets. Mr. Davin warned of four areas that needed to be addressed: (1) exchange of information among marketplaces and regulators; (2) facilitation of global delivery; (3) avoidance of the piecemeal initiation of rulemaking in the absence of substantive experience; and (4) the presence of cultural differences among markets and differences between unsophisticated and institutional investors. Chairman Shad agreed that differences in levels of sophistication should be considered. Furthermore, Chairman Shad stated that he believes that since international markets appear to be largely institutional markets, the question is whether to develop regulations that might diminish the efficiency of these markets for the benefit of small investors who are such a small segment of the market.

Mr. Ketchum next addressed a question to Mr. Knight. In response, Mr. Knight stated that the ISE intends to develop a marketplace for trading of U.S. and other non-U.K. securities both during and after U.S. trading hours. Mr. Knight eiterated his earlier remarks that this market would be regulated and visible.

In response to a question from Commissioner Grundfest, Mr. Knight then indicated that the trading of U.S. securities in Europe is largely inter-professional, and, as such, is unlikely to be "refugee trading," i.e., trading occurring abroad to avoid U.S. restrictions. Mr. Knight acknowledged, however, that some U.S. banks trade in London because they cannot do so in the U.S. under the Glass-Steagall Act.

The next topic introduced by Chairman Shad was international clearance and settlement. The commentators on this topic were Richard Myers (ISCC) and Mr. Knight. Mr. Myers stressed the necessity of developing efficient, coordinated, cross-border settlement capabilities. According to Mr. Myers, international dealers face a greatly increased risk that trading profits will become administrative losses, in the absence of efficient processing systems. He pointed to centralized clearing systems in many national markets and in the Eurobond markets as examples of one theoretical solution -- a single global clearing system or

set of standards. Mr. Myers noted that as a first step, national clearance and settlement systems have begun to link with each other providing their participants with the ability to operate within, and not outside national markets. As an example, Mr. Myers noted ISCC's link with the ISE settlement system. The link has enabled ISCC participants to clear trades on a par with ISE members as dealers, not customers. Mr. Myers stated that he believes that there should be an active international clearance and settlement capability by the end of 1987 or early 1988. Mr. Meyjes agreed with Mr. Myers that the goal of national clearance and settlement systems must be to forge sophisticated and operationally viable links.

Mr. Knight commented on difficulties the International Federation of Stock Exchanges encountered 20 years ago when it tackled the subject of achieving greater cooperation among European clearance and settlement systems. In particular, Mr. Knight referred to the "legal impossibility" of admitting non-national members to national clearing systems. Mr. Knight stated that he believes that progress has been made on this issue, however, and cited the link with ISCC as an example. He also mentioned that the ISE successfully has negotiated links with France, Spain, South Africa, Germany, Australia and Japan.

In response to a question from Commissioner Peters, Mr. Myers expressed the view that the Commission's current approach to reviewing linkages between U.S. and foreign clearance and settlement systems on a "no-action" basis should be continued. He believes this approach: (1) encourages in-depth examination of the issues from the perspective of both parties to the link; and (2) makes publicly available the Commission's policies on the development of international clearance and settlement linkages. Mr. Knight also favored the no-action approach, emphasizing the importance of working with the staff on a case-by-case basis. Mr. Davin also encouraged the Commission to continue its reactive approach to the issue of international clearance and settlement. He believes that industry, in the first instance, should be given the opportunity to attempt to solve international clearance and settlement problems.

In response to a question from Commissioner Peters, Mr. Meyjes stated that settlement problems are systemic rather than regulatory, largely resulting from 20 different major markets with different settlement practices. Mr. Meyjes also indicated that, to some extent, the problem is self-correcting. He stated his belief that markets that do not improve their clearance and settlement systems will lose market share because investors will desert markets where the cost of settlement exceeds the

investment benefits of the securities. Mr. Meyjes said that these competitive forces already are promoting improvements.

The discussion next turned to whether regulatory adaptations are necessary to prevent trading volume from moving offshore to avoid domestic regulation perceived as more restrictive than that in foreign markets. Mr. Birnbaum (NYSE) commented first. Mr. Birnbaum cautioned against undercutting a regulatory framework that makes U.S. markets fair and equitable for all participants in the quest for more competitive markets. Mr. Birnbaum used the short-sale rule as an example, suggesting that some change to the rule would be beneficial to discourage traders from going to other jurisdictions without short-sale rules. He believes, however, that the solution must not compromise the rule's regulatory rationale.

Mr. Liftin (Quadrex Securities, Inc.) also commented on whether regulatory adaptations are necessary. Mr. Liftin stated his belief that offshore trading may occur to avoid insider trading rules, the NASD mark-up policy and, of course, off-board trading restrictions. Although Mr. Liftin commended the Commission and the NYSE for their willingness to re-examine their trading rules, he cautioned against a "competition in laxity." He agreed with a comment by Mr. Oyens that such a loosening of trading rules would risk approaching the lowest common denominator

among all the different markets. Furthermore, he believes that foreign investors, in fact, prefer to trade U.S. securities in U.S. markets, perceiving them as fair and equitable. Mr. Knight agreed with this observation.

Commissioner Grundfest echoed Mr. Liftin's statements that the level of regulation in a market defines the quality of the market. The Commissioner, using as an example insider trading, stated that he believes that the higher risk that a securities purchaser will end up on the "wrong side of an insider trading transaction in markets without insider trading protections, is reflected in the price of the security."

Mr. Davin suggested to the panel that a more innocent motive compels many traders to trade offshore and that time differences account for a great deal of such trading. He contends, for example, that it is obviously unrealistic for Japanese traders to stay in their offices until the middle of the night to trade U.S. securities on the NYSE or the Amex when they are open.

Mr. Leibler raised the question of whether the Commission should permit U.S. exchanges to revise their foreign listing standards. He stated that he believes that adaptation of these standards would enhance U.S. exchanges' competitiveness. Mr. Birnbaum agreed, stating that American investors are now buying foreign securities outside the U.S. that may not meet U.S.

listing standards. He therefore believes that permitting U.S. exchanges to adapt foreign listing standards will make the exchanges more competitive without increased risk to U.S. investors.

Mr. Birnbaum also was asked to comment on whether the proliferation of international affiliates complicates the NYSE's efforts to ensure the financial responsibility of its member firms. Mr. Birnbaum expressed great concern over the issue. He stated that the primary problem is the exchange's lack of authority to routinely examine the activities of foreign affiliates. Potential solutions Mr. Birnbaum identified include: (1) forging agreements among governments on the disclosure of relevant surveillance and financial responsibility information; (2) adopting uniform financial reporting and accounting standards; and (3) working toward eliminating the obstacles that blocking statutes create.

The final topic for the morning session of the Roundtable was barriers to entry into non-domestic markets. Mr. Fernandez spoke first on the difficulties non-U.S. firms face in attempting to break into U.S. markets. Mr. Fernandez seemed to believe that the most formidable "barrier" is a subtle one: a lack of clarity in the laws and regulations governing the activities in which foreign firms may engage. Mr. Fernandez pointed to what he considers "grey areas" in the Commission's policies on what foreign securities can be traded in the U.S. and when they may be traded. He believes that substantial questions remain on

seasoning requirements for stocks, the ability of U.S. investors to exercise rights or warrants on Japanese securities, private placements, and off-board and after-hours trading of exchange-listed securities.

Mr. Meyjes spoke from the perspective of a U.S. firm attempting to establish a competitive position in non-U.S. markets. He stated that, particularly in the last several months, substantial inroads have been made on several fronts. For example, he cited the recent loosening of restrictions on foreign firm participation in Ontario and Singapore. He also noted that the highly regulated French markets recently have given some indication that they are moving to liberalize their markets. He noted, however, that there are also subtle barriers to entry in the form of custom and "competitive behavior." As an example, he mentioned the difficulty a U.S. firm experiences gaining access to foreign underwriting syndicates, particularly in Japan.

Mr. Davin also applauded the recent deregulatory moves in many countries that are easing barriers to entry into their markets. He also suggested that the next step might be to link broker-dealer organizations internationally through the international clearing organizations.

Mr. Liftin commented on what he termed "self-imposed" barriers to entry in the Euromarkets. He cited Euromarket

participants' reluctance to deal with firms whose financial capability is not proven to them, and to the Euromarket clearing entities, Cedel and Euroclear, whom, he believes, have extraordinarily high financial standards for member firms. He also believes that Euromarket participants insist on dealing with firms with a reputation for being highly professional.

Mr. Liftin agreed with Mr. Meyjes that many barriers to entry are indeed cultural. He cautioned against the U.S. conditioning access to non-U.S. firms, however, on reciprocal treatment from the foreign country. He believes that the cost to U.S. markets of excluding foreign participants would be decreased liquidity in U.S. markets and would not outweigh the benefits of compelling some foreign markets to grant access to U.S. firms.

Richard Ketchum next summarized the morning's discussion. He identified areas of consensus as: (1) the existence, for at least institutional trading, of a 24-hour market; (2) the continued pre-eminence of the home market for customer activity and necessary liquidity; (3) the need to further develop international clearance and settlement mechanisms; (4) the necessity of intergovernmental and self-regulatory information and surveillance sharing agreements; (5) the need to develop methods to disseminate market information, both quotes and last sale information; and (6) the desirability of the Commission's reactive approach to dealing with developments in the internationalization arena.

Chairman Shad concluded the session by emphasizing his agreement with the notion that the Commission should let the internationalization of the world's securities markets occur without undue interference from regulators. He also took the opportunity to praise the recent successful negotiations on obtaining information sharing agreements.

Five key areas were the focus of the afternoon session: offerings of securities abroad; "flowback" into the United States; creation of a "free trade zone" for institutional trading of unregistered securities; restrictions on distribution participants in international offerings; and foreign broker-dealer activity in the United States.

The first question raised was the appropriate reach, if any, of the Securities Act registration process to offshore financings. Edward Greene (Cleary, Gottlieb, Steen & Hamilton) began the discussion by summarizing the purposes of Securities Act Release No. 4708, which permits a foreign offering to be made using jurisdictional means without registration provided the distribution is done abroad. He said the release was promulgated because the U.S. securities laws were primarily designed to protect U.S. persons, a term that probably includes both nationals, wherever located, and residents. He noted that procedures followed to assure securities come to rest abroad pursuant to the release have developed through the "no-action" process and that, given the growing interest in securities

denominated in other currencies and issued by issuers in other countries, the current structure needs to be revisited, particularly the reach of the Securities Act. His view was that the Act should apply to offers and sales in the United States only and should not apply to offers and sales outside the United States by any issuer, U.S. or non-U.S., to nonresidents of the United States. He also expressed the view that corporate, insurance company, and bank branches operating in a jurisdiction abroad where they are regulated should be treated as nonresidents. He believed transactions with foreign-based investment advisors or fiduciaries should be treated as nonresident transactions if those advisors are acting with discretion and that, if the sale is made offshore to a foreign advisor with discretion, the transaction should not be subject to the Securities Act even if the beneficiary is a U.S. entity. He suggested that international banking facilities be carved out and that a targeted offering at offshore persons such as U.S. armed forces personnel should be subject to the Securities Act. He said that a territorial approach does not mean we have to be insensitive to flowback, but it need not be as elaborate as at present. He further said that it would be a mistake to impose Exchange Act reporting requirements on issuers simply because their securities flow into the United States unless the issuers have taken voluntary steps to enter the United States.

Neal Garonzik (Morgan Stanley) then identified certain major problem areas: (1) the anomaly between the lack of Exchange Act protection U.S. investors receive when they go offshore and that which is mandated under the Securities Act; (2) the need to keep our capital markets and participants competitive while preserving the quality of our markets; (3) the question of who is protected under the U.S. laws; and (4) practical problems of implementation because of the "fungibility of securities in a world of electronic clearance mechanisms. He advocated continued encouragement by the Commission of its counterparts in principal overseas markets to adopt more stringent disclosure standards, an exemption from registration for sales to institutions, varying holding periods after which securities may be sold into the United States for different classes of investors, differentiation between issuers who are Exchange Act reporters and those who are not, and differentiation between investment grade bond issues and lower-rated securities and between common stock and convertible bonds.

After discussion, Commissioner Grundfest noted the consensus of the group that the Securities Act imposes some artificial impediments and costs on operation of the markets with minimal benefits. Commissioner Fleischman qualified that the consensus applies to initial public offerings. Mr. Greene stated there is also a consensus that some flowback restrictions are required to prevent evasion of the Securities Act, but the present ones

are too extensive and costly. He also expressed the view that one error in the distribution procedure should not cause the entire offering to be in violation of the Securities Act.

Mr. Greene and William Williams (Sullivan & Cromwell) then discussed with Commissioner Fleischman and Chairman Shad drawing a "bright line" for a flowback time and whether a pre-existing market in the United States should make a difference. The discussion was inconclusive, but Mr. Williams stated that caution must be taken when drawing lines based on the state of the market at the time the resale is made, which would be a moving target. He also suggested it would be a mistake to set an objective time period in excess of six months.

Moving ahead on the agenda, Commissioner Peters and Mr. Greene then discussed the appropriate definition of institutions, if a distinction is made between resales to institutions and others of securities initially sold abroad without registration. Mr. Greene said that the obvious core would be mutual funds, pension funds and insurance companies and beyond that banks and financial institutions should probably be included. It was agreed that individuals should be excluded initially.

A discussion followed regarding the change in disclosure and resulting lack of comparability that would occur if institutions were allowed to "fend for themselves." Mr. Greene expressed the view that this is not a problem in the debt market because of rating agencies. It remains a problem with common stock, however, in that if compliance with the Securities Act is required, the issuers will not sell in the United States.

In summary, with respect to the first issue, a consensus was reached that a territorial approach to application of the Securities Act is needed. It was agreed that offers and sales within the United States, including offers and sales to foreigners temporarily present in the U.S., should be protected, and that offers and sales to U.S. citizens residing abroad should not be protected. No consensus was reached on whether offers and sales to U.S. residents who purchase in overseas markets should be protected. Participants left open the question of how to define the location of an offer or sale, a particularly important question when orders are placed telephonically. Also unresolved was how to protect against offerings targeted to the United States through foreign markets. It was generally agreed, however, that such protections must be provided if a territorial approach is adopted.

The next issue was then formally addressed: "If offshore sales are limited in some fashion, what would be the effect of creating a 'free trade zone' for institutional trading of unregistered securities"?

John Mayer (Morgan Guaranty Trust Company) noted that, particularly in equity issues, most trading has migrated back to the home market for liquidity.

Mr. Williams then described the "free trade zone" concept as an exemption from the registration requirements of the Securities Act for offers and sales by the issuer to institutional

accredited investors and resales by those institutions to other institutional accredited investors. He suggested that it could supplant a significant portion of shelf-registered debt issues and that the question is whether there would be limitations, such as eligible issuers (those registered under the Exchange Act) or eligible securities (debt only, or investment grade only). Mr. Williams commented that primary sales abroad cannot be limited to institutions because the Euromarket includes individuals. In terms of resales, he recommended permitting such sales after some relatively brief period into an organized trading market abroad without inquiry as to the buyer, at least in the case of equity securities sold on a bona fide exchange. He also believed that any such exemption should allow resales into the United States for securities of qualified issuers at any time.

Peter Clapman [College Retirement Equities Fund ("CREF")] stated that CREF was losing millions of dollars as a result of regulation, particularly because U.S. persons are excluded from foreign rights offerings and that the idea of an institutional market is an appropriate way to reduce prejudice to American investors and not jeopardize regulatory responsibilities.

Mr. Greene expressed his view that the 4(1-1/2) exemption is sufficient in the debt market but, with respect to the equity markets, he may have concerns if tacking is permitted and at some point securities can leak into the U.S. market where appropriate information is not provided.

Charles Whitman (Davis, Polk & Wardwell) said that the "clear word you are hearing is that if you don't change your rules, you are exporting the market and that's a bad idea."

With respect to the type of securities that could be sold under such an exemption, Mr. Williams stated that a limitation of the exemption to reporting companies and investment grade debt substantially ignores foreign securities and that there should be no concern if it is opened up to equity securities.

A concern was expressed, however, by another participant that a two-price market may result for domestic equity securities, though in the international arena, arbitrage might decrease the price differential between the foreign market and the U.S. market.

The third area, the ability of foreign companies to undertake public offerings in the United States, was then addressed. Douglas Hawes (LeBeouf, Lamb, Leiby & McCrae) stated his approval of a reciprocal approach initially on a limited basis of the debt of certain world-class issuers. He then said that the reason foreign companies do not enter U.S. markets is the liability issue and fear of the SEC and unknown changes. He said the accounting and disclosure issues are minor. He recommended a mechanism whereby foreign companies who register in the United States would not have to comply with any new requirements for a period of time, during which they could extricate themselves from jurisdiction.

David Meachin (Merrill Lynch Capital Markets) commented that the reciprocal prospectus may be important for large quality corporate issuers that do rights offerings, particularly to provide direct access to the issue by individuals and expressed his approval of the free trade zone concept. He also suggested that because offerings made concurrently in different jurisdictions may be expected to become more prevalent, the Commission should focus on facilitating timing of these issues prior to marketing. He also commented that abiding by Commission rules regarding publication of research material puts U.S. broker-dealers behind foreign broker-dealers.

John Liftin (Quadrex Securities Corporation) stated that it would be an error to minimize the difficulty for foreign issuers of complying with SEC accounting and disclosure requirements, focusing on the problem of segment reporting. He also addressed the rights offering problem and recommended that rights issues be permitted, provided there is no distribution or selling effort.

Mr. Knight added that rights offerings remain a convention in many parts of the world but noted that the U.K. has eliminated the strictest of its preemptive rights requirements. There was then a discussion of the fairness of treating foreigners leniently and exporting U.S. capital. Mr. Meachin stated that capital is already exported through foreign secondary markets and will continue to be exported one way or another.

Following was a discussion of whether the reciprocal approach would be used, if available. Mr. Greene expressed the view that, because of liability, if alternatives are available, they will be used. Mr. Williams raised the concern of liability in reciprocal prospectuses that permit omission of information required by U.S. issuers. Linda Quinn, Director, Division of Corporation Finance, stated the form could specify that no more disclosure is required and added that equity securities across the board would probably not be included. Mr. Meachin stated his view that even for equity, world-class issuers should be included in the reciprocal approach.

The Chairman then introduced the discussion of Rules 10b-6 and 10b-7 under the Exchange Act. Mr. Whitman commented that the staff of the Commission has been very responsive to issues under Rules 10b-6 and 10b-7 in international offerings. Mr. Whitman stated that, in the past, Rule 10b-6 was applied to foreign portions of U.S. offerings even though foreign underwriters were not aware that they were subject to Rule 10b-6.

Mr. Whitman stated that foreign markets differ from U.S. markets, and he maintained that imposing on foreign underwriters U.S. rules that restrict various market participants from buying securities where there is a U.S. tranche of an offering, because such purchases might have an effect on raising the price of the security in the foreign market, might serve to reduce the

chances of any U.S. offering of foreign issues. Mr. Whitman stated that the staff had tailored no-action letters under Rule 10b-6 to reflect the realities of the international markets and referred specifically to recent multinational securities offerings of British and French companies.

Finally, Mr. Whitman said that prior to "Big Bang," the underwriters in a British offering could represent that they would not buy for their own accounts to facilitate market transactions. Because "Big Bang" permitted underwriters to become affiliated with "jobbers" and brokers, they can no longer make those same representations. He noted that on an oral basis the Commission staff has permitted the same representation to apply, taking into account British firms' Chinese Walls between their underwriting and trading facilities.

Gregory Sacco (Shearson Lehman Brothers, Inc.) observed a proliferation of U.S. issuers doing simultaneous domestic and European tranches. He thought this was beneficial and has brought investor interest in securities on a primary placement basis as well as in the aftermarket. In such offerings, he said it is a settled practice that non-U.S. syndicate participants defer to U.S. regulations, and defer to U.S. underwriters to execute Rule 10b-7-related transactions.

Mr. Garonzik said that he found the European market much more acclimated to bond issues which are often sold on a variable

price basis. He also suggested that even though non-U.S. firms were content to leave Rule 10b-7 matters to managing underwriters, as a practical matter he thought there were frequently unwitting violations of Rule 10b-6 in fixed price equity offerings. This is so because the purchasers pay different prices for such securities without disclosure of that phenomenon. He was not confident that managing underwriters could do adequate policing of this matter.

Mr. Williams suggested that where the principal trading market is in the U.S., the rules should apply just to the U.S. market and should not be applied offshore. He suspected that it was difficult, inefficient, and uneconomic to manipulate the stock of a number of U.S. issuers by transactions in that stock abroad and relying on arbitrage to affect the U.S. market. Mr. Whitman responded that if the Europeans nevertheless choose to engage in such trading it will have the manipulative effect that Rule 10b-6 was designed to prevent. Mr. Davin agreed with Mr. William's assessment and said that he would favor an exception from Rule 10b-6 where the portion of the offering abroad is de minimis relative to the U.S. portion; for example, under 20% of the overall offering. With respect to foreign issuers offering securities in the U.S., however, Mr. Williams said that manipulation of the issuer's price in its home market would have a direct impact on the price of the security in the U.S.

The Chairman inquired as to whether there would be arbitrage opportunities and Mr. Garonzik said there would be. In addition, Mr. Ketchum thought that there is flowback going back and forth daily between U.S. and foreign markets in U.S. securities. He inquired as to why that buying activity in the foreign market would not flow back into layoffs in the U.S. Mr. Davin suggested that the flowback problem might be exaggerated.

The Chairman asked Mr. Ketchum whether there was any evidence of abuse in this area. Mr. Ketchum responded that Rule 10b-6 serves as a deterrent so it is difficult to measure abuse. Mr. Ketchum asked whether there was any difference in the likelihood of manipulation through arbitrage or flowback in larger issues with large public floats or with respect to smaller, more speculative issues. Mr. Williams maintained that small U.S. issuers would not have significant foreign trading markets, and that it was unlikely there would be price manipulation in such securities by transactions outside the U.S. He apparently believed that the securities of a NYSE-listed issuer could be manipulated in London after trading had ended for the day in the U.S.

The final session focused on U.S. broker-dealer activity abroad and efforts by foreign broker-dealers to enter the U.S. markets. The first commentator was Charles Whitman. Mr. Whitman initially discussed the effect that linkages have had in requiring the Commission to permit foreign entities to provide at least

quote information in the U.S. without registering as broker-dealers. He acknowledged that the staff seems to have backed away from its previously outstanding position prohibiting dissemination of research in the U.S. by a foreign entity and now permits research to be disseminated in the U.S. if a registered U.S. broker-dealer assumes responsibility for the information provided.

Mr. Whitman then discussed the fact that most U.S. broker-dealers conduct their foreign business through foreign-based affiliates that are not registered in the U.S. as broker-dealers. In his view, although the foreign affiliates could be seen as doing business in the U.S., the parent broker-dealer's registration thus far has precluded questions as to whether the foreign affiliates should themselves register as broker-dealers. He questioned whether a U.S. broker-dealer should be permitted to shield its foreign subsidiary from the broker-dealer registration requirements if the subsidiary engages in business in the U.S. He continued this line of thinking by asking whether foreign entities with U.S.-registered affiliates should be required to register if their business overlaps into the U.S. Mr. Whitman suggested that U.S. registration was not necessary for foreign-domiciled entities because the Commission had access to the entities and their actitivies through the shingle theory.

The second commentator was James Davin (First Boston Corporation). Mr. Davin discussed broker-dealer issues very

briefly and then moved to other issues. With regard to broker-dealer registration, he noted his view that as long as the activities of foreign broker-dealers in the U.S. are limited to dealings with other broker-dealers, and other sophisticated institutions, broker-dealer registration is unnecessary. He considers, however, broker-dealer registration necessary if a foreign entity is engaged in a full-service securities business.

At the conclusion of these comments, Mr. Ketchum questioned how the U.S. could adequately ensure against the movement of U.S.-barred persons from U.S. entities to their foreign affiliates. He asked whether this concern might be alleviated by treatment of the personnel of foreign affiliates as associated persons of the U.S. entities. Mr. Whitman responded to Mr. Ketchum's concerns by agreeing that a "front man" doing business in the U.S. for a foreign entity would defeat the purposes underlying the broker-dealer registration requirement. Mr. Whitman expressed the view, however, that a foreign entity not doing business in the U.S., or legitimately directing business through a U.S.-registered broker-dealer, should not be subject to the Commission's jurisdiction, absent misdeeds involving U.S. jurisdiction. Mr. Ketchum also asked whether U.S. affiliates of foreign broker-dealers should be required to be involved in all aspects of a foreign parent's sales activities in the U.S. Mr. Whitman responded to this question by noting that, at present, foreign entities send sales personnel to the U.S., but all sales efforts are made in conjuncion with, and in the presence of, representatives of the U.S.-registered affiliate.

The final commentator, William Wilby (AIG Global Investors), discussed management of international funds. He noted that in managing an international fund, performance is weighed against a non-U.S. index, with most returns resulting from successful selection of markets, rather than instruments. He listed several factors that are assessed in determining whether or not to invest in a particular market, including politics, interest rates, local investing patterns and various market risks. Mr. Wilby expressed the view that individual investors may not be able to diversify away risks in the international markets, but institutional investors are able to do so.

At the end of the afternoon session, Ms. Quinn summarized the Division of Corporation Finance issues as follows:

1. There was overwhelming endorsement of the territoriality approach; offshore sales of reporting companies would require some protection against flowback; offshore affiliates and other institutions, onshore and offshore, could buy foreign securities without registration; there was some sentiment for allowing offshore sales be made to U.S. residents, but the question of how to define the locus of the offer and sale was not addressed.

2. There was sentiment that flowback protections need to be simplified; holding periods defined and preferably shortened and a distinction between convertible securities and common stock.

3. With respect to the institutional free trade zone, there was a consensus that it is a great idea but as yet is undefined and unclear as to whether it should be limited to certain classes of securities or classes of issuers. The problem of two-tier pricing was raised and any free trade zone should be done in tandem with revision of Release No. 4708.

4. Resales onto established secondary trading markets by institutions taking in private placements must be permitted.

5. With respect to reciprocity, there was widespread endorsement but substantial skepticism as to whether this approach would in fact be used by many issuers. There were fears of the SEC, Congressional legislation and liability and a suggestion that timing risks be reduced. There was also a question about research reports for U.S. brokers where foreign brokers are unregulated.

6. The need to address the problem of disparity between foreign and domestic issuers was also raised.

Mr. Ketchum concluded the afternoon session by recapping the discussion on Rules 10b-6 and 10b-7 and on foreign broker-dealer registration. Mr. Ketchum stated that the panel generally agreed that the Commission has shown adequate flexibility in applying Rules 10b-6 and 10b-7 where the primary market for a distribution exists abroad. Mr. Ketchum noted that the panel was not agreed on whether the Rules should be applied to foreign trading where the primary market was in the U.S.

The panel split on the question of foreign broker-dealer registration. Mr. Ketchum noted that some panelists believed registration should not be required of foreign broker-dealers who disseminate research in the U.S. as long as a registered U.S. broker-dealer assumes responsibility for the information provided. Mr. Ketchum also noted that some panel members believed that non-registration of foreign broker-dealers conducting these activities gave them an unfair competitive advantage over their U.S. counter-parts and believed that they should be required to register if their selling actitivies extended to customers other than broker-dealers and banks.

Chairman Shad next asked Gary Lynch, Director, Division of Enforcement, if he had any comments on the day's discussion. In response, Mr. Lynch remarked that he agreed with earlier commentato on the importance of information sharing arrangements and regulator access to customer information.

Chairman Shad then thanked the participants and concluded the session.

Attachment A

Briefing Memorandum

Internationalization Roundtable
Participants and Discussion Topics

The Internationalization Roundtable to be held at the Commission on February 17, 1987, will be divided into a morning and an afternoon session. The morning panel will discuss secondary market and clearance and settlement issues and the afternoon panel will discuss primary offering issues. The participants in each panel will be:

Morning Session: Secondary Market Issues

Kenneth R. Leibler, President
American Stock Exchange, Inc.

Gerrit de Marez Oyens, Secretary General
Amsterdam Stock Exchange

C. Robert P. Meyjes, Senior Vice President
Citicorp Investment Bank

Richard W. Myers, Senior Vice President, Operations
International Securities Clearance Corporation

Jeffrey Knight, Chief Executive
International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd.

James M. Davin, Vice Chairman, Finance
National Association of Securities Dealers, Inc.

Robert J. Birnbaum, President
New York Stock Exchange, Inc.

Brian Fernandez, Senior Vice President
Nomura Securities International Inc.

John M. Liftin, President
Quadrex Securities Corporation

Donald Unruh, Vice President
Toronto Stock Exchange

Afternoon Session: Primary Offerings

William L. Wilby, Managing Director
AIG Global Investors

Gerrit de Marez Oyens, Secretary General
Amsterdam Stock Exchange

Edward F. Greene
Cleary, Gottlieb, Steen & Hamilton

Charles S. Whitman, III
Davis, Polk & Wardwell

James M. Davin, Managing Director
First Boston Corporation

Jeffrey Knight, Chief Executive
The International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd.

Douglas W. Hawes
LeBoeuf, Lamb, Leiby & MacRae

Roderick M. Hills, Chairman and Managing Director
The Manchester Group Ltd.

David J.B. Meachin, Managing Director
Merrill Lynch Capital Markets

John A. Mayer, Jr., Senior Vice President
Morgan Guaranty Trust Company

Neal S. Garonzik, Managing Director
Morgan Stanley & Co., Inc.

Peter C. Clapman, Senior Vice President and Associate General Counsel
Teachers Insurance and Annuity Association/College Retirement Equities Fund

Gregory Sacco, Jr., Executive Vice President
Shearson Lehman Bros., Inc.

William J. Williams, Jr.
Sullivan & Cromwell

I. MORNING SESSION

A. International Secondary Market Trading Mechanisms

The bulk of transnational secondary market securities transactions currently occurs in an over-the-counter environment, principally between large dealers and institutions trading over the telephone or via other telecommunications systems. Intermarket trading linkages, however, have been established in the last two years, including: (1) the American ("Amex") and Toronto Stock Exchanges ("TSE") link; (2) the Boston and Montreal Stock Exchanges link; and (3) the TSE and Midwest Stock Exchange link. The National Association of Securities Dealers ("NASD") and International Stock Exchange of the United Kingdom ("U.K.") and the Republic of Ireland ("SE") also have implemented a quotation exchange mechanism. Agreements in principle have been reached between the SE and the Philadelphia Stock Exchange and the Amex and European

Options Exchange to trade fungible options contracts in foreign currency and index options, respectively. Finally, TSE officials have suggested the development of an alternative market structure, which could include the consolidation of trading in a single central limit order book in the home market of internationally traded issues.

The Commission is interested in discussing:

- the mechanics and utility of these different transnational trading systems;
- the benefits and risks of the rapidly increasing internationalization of the securities markets;
- likely future developments;
- problems anticipated in further linkages of the markets; and
- other steps that might be taken, similar to the Intermarket Surveillance Group.

B. Information Sharing Agreements

As a part of the Canadian/U.S. market linkages, and in other contexts, the Commission and various foreign government agencies have developed bilateral agreements for the routine exchange of surveillance information and the provision of mutual investigatory assistance. See attached Division of Enforcement Memorandum describing these agreements. Similarly, marketplaces entering into linkage arrangements have executed information exchange agreements. One of the major concerns in developing these agreements has been the Commission's need to obtain evidence and other information relevant to the enforcement of the U.S. securities laws. As described in the attached Division of Enforcement Memorandum, the Commission also has worked on the development of multilateral accords in this area. The Commission is interested in discussing the existing agreements and any experience to date under these agreements. These questions also arise:

- What are the principal legal issues and impediments (e.g., blocking statutes and secrecy laws) affecting the transnational exchange of information?
- What bilateral and multilateral agreements should be developed in the future?
- What should be the nature of these agreements?

C. Market Information

The availability of market information (quotations, last sale prices and volume) in the various major international markets differs. Furthermore, aside from the internal telecommunications systems of broker-dealers, there is no facility for consolidating on a global basis the information that is available regarding securities that trade in more than one national market.

The Commission is interested in discussing:

° the differing practices in the major international markets in regard to dissemination of quotations, last sale and volume reporting;

° the systems broker-dealers use to collect and consolidate information; and

° the prospects and problems of global market information consolidation.

D. International Clearance and Settlement

The largely manual clearance and settlement systems of some markets, as well as the lack of adequate transnational clearance and settlement mechanisms, remains one of the major obstacles to the development of international secondary trading markets. The Commission has approved several clearance and settlement linkages (e.g., the links between the Midwest Clearing Corporation/Midwest Securities Trust Company, the Canadian Depository for Securities ("CDS"), the Vancouver Stock Exchange Services Corporation and the SE, and between the National Securities Clearing Corporation ("NSCC") and CDS). Also, NSCC has formed the International Securities Clearing Corporation to facilitate international clearance and settlement linkages. The bulk of transnational trades, however, still settle outside of organized clearance systems, largely via Telex and physical deliveries of certificates.

The Commission is interested in discussing:

° clearance and settlement problems and the steps the Commission and the industry can take to accelerate progress in this area;

° the standards for foreign membership in a U.S. clearing agency;

° whether clearing agencies should be permitted to rely on foreign financial responsibility standards in ensuring the credit worthiness of a foreign member;

- how U.S. clearing agencies should assure the financial responsibility of linked clearing agencies and their members; and

- whether responsible government agencies should attempt to reach a multilateral agreement on minimum clearance and settlement standards for active trading markets.

E. Regulatory Adaptations

The proliferation of active international securities affiliates of U.S. broker-dealers (and active U.S. securities affiliates of foreign broker-dealers) arguably has complicated for regulators in each country the job of enforcing their rules and monitoring the financial responsibility of their registered broker-dealers. In addition, many of the increasingly efficient and accessible foreign markets for U.S. securities have different rules and restrictions than the Commission or U.S. self-regulatory organizations ("SROs").

- Has the proliferation of international securities affiliates weakened the ability of any regulator to assure the financial responsibility of its securities markets?

- Should the Commission and the SROs adapt any of their rules (*e.g.*, short sale rules) to the increasing internationalization of secondary markets?

F. Barriers to Entry

The federal securities laws provide for the national treatment of all broker-dealers, *i.e.*, both foreign and U.S. broker-dealers are entitled to establish and operate securities businesses on equal terms. While much progress has been made in recent years in opening foreign markets to U.S. broker-dealers (*e.g.*, the Tokyo Stock Exchange providing four seats to U.S. firms, and the U.K. and Canada opening up access to their markets to foreign broker-dealers); barriers to entry remain in some markets.

The Commission is interested in discussing:

- the progress made in this area;

- the particular barriers that remain and in which markets;

- what the Commission's role should be in eliminating such barriers.

II. AFTERNOON SESSION

A. Offerings of Securities Abroad, "Flowback" Into the United States and Creation of a "Free-Trade Zone" for Institutional Trading of Unregistered Securities

A 1964 Commission release (Securities Act Release No. 4708) stated that the Commission would not take enforcement action for failure to register under the Securities Act if a domestic issuer sold its securities abroad solely to foreign investors and the securities "came to rest" abroad. The increasing internationalization of the securities markets and regulatory changes since the Commission issued Release No. 4708 call for review of the concepts underlying the release.

1. What should be the reach, if any, of the Securities Act registration process to off-shore financings?

   - Should it reach, as at present, to any offering to U.S. nationals or U.S. residents?

   - Should it instead be limited to offerings in the U.S. capital markets (i.e., along geographic lines)?

   - If so, how should geographic lines be drawn?

   - As part of a geographic approach, should there be any restrictions on sales that are made to U.S. residents offshore?

   - Should there be a distinction in any such approach between reporting and non-reporting issuers?

   - If sales are permitted to U.S. residents in distributions abroad without flow-back restrictions, should it make a difference whether there was an established trading market for the securities of the issuer in the foreign market or in the U.S. prior to a distribution into the foreign market?

   - If there were no restrictions on flowback, would the availability of the exemption provided foreign private issuers from registration under Section 12(g) of the Exchange Act pursuant to Rule 12g3-2(b) require reconsideration? If so, how would we enforce compliance with Section 12(g)?

- If sales could be made without restriction to U.S. residents abroad, would primary offerings be likely to be driven offshore?

- If limitations should be placed on sales to U.S. residents or nationals, what should those limits be?

2. <u>If offshore sales are limited in some fashion, what would be the effect of creating a "free-trade zone" for institutional trading of unregistered securities?</u>

   - What would the implications of such an approach be on established trading markets?

   - Would this approach increase the likelihood of primary offerings and secondary trading of foreign equities in the United States?

   - Should any such "free-trade zone" be restricted to certain types of securities (<u>e.g.</u>, investment grade senior securities) or to the securities of reporting companies?

3. <u>A related issue is the ability of foreign companies to undertake public offerings in the United States.</u> A reciprocal approach, without any reconciliation to U.S. disclosure requirements, under which offering documents accepted in the home jurisdiction could be used in the United States for British and Canadian issuers is being explored for offerings of investment-grade debt by world-class issuers, and certain exchange and rights offerings.

   - To what extent would a reciprocal approach encourage foreign issuers to sell securities in the United States?

   - Would an institutional free-trade zone result in minimal reliance on a reciprocal registration process or would it provide a valuable alternative to an institutional free trade zone, and in what cases?

B. Restrictions on Distribution Participants in International Offerings

Presently, no-action and exemption letters take the position that during a distribution of any security (debt or equity) with a market in the United States, market activities of distribution participants must be conducted in compliance with Rules 10b-6 (which prohibits, with certain exceptions, trading by persons interested in a distribution of securities) and 10b-7 (which governs stabilizing to facilitate a distribution of securities) under the Exchange Act unless an exception from those rules is available or exemptive or no-action relief is granted. (See, e.g., Letter regarding Louis Vuitton S.A. (June 21, 1984) and Letter regarding British Petroleum Company (September 15, 1983) with respect to Rule 10b-6; see Letter regarding Tricentrol Limited (July 2, 1980) with respect to Rule 10b-7. See also Securities Exchange Act Release No. 21958 (April 18, 1985) ("Release 34-21958"), where the Commission discussed the application of Rules 10b-6 and 10b-7 to international offerings.

Two commentators responding to Release 34-21958 opined that the case-by-case approach taken by the staff in the international distribution context had proven effective, but suggested that general guidelines or rule amendments be formulated to provide greater guidance as to the application of the rules. Other persons have recommended other approaches. In a number of international offerings, the foreign underwriting syndicates have included contractual provisions designed to achieve compliance with Rules 10b-6 and 10b-7.

Should a change be made in the basic concept of Rules 10b-6 and 10b-7 when applied to international offerings, or should the existing concept be streamlined and adapted to the present markets?

- Given the international character of the securities trading markets, can the application of the rules be limited by geographical boundaries, either with respect to the location of the distribution or the market activities of the distribution participants?

- Should it make a difference whether there is an established United States trading market for the issuer's securities? Does it make a difference if the United States does not have the primary market for the securities?

- If the rules should continue to apply to international offerings, should they be revised in any way to accommodate present syndicate practices abroad?

- Should the rules continue to apply to transactions in debt securities outside the United States?

C. Foreign Broker-Dealer Activity In the United States

Foreign entities wishing to conduct a securities business in the United States or with U.S. investors generally must comply with the Commission's broker-dealer registration requirements. However, the Commission, by exemptive order, and the Division of Market Regulation, by no-action letter, recently have indicated that foreign entities may participate in certain securities activities in the United States without broker-dealer registration, subject to specific limitations and conditions.

The Division of Market Regulation has granted temporary no-action positions to the SE two programs established to permit SE market makers to provide continuous quotations in the United States with respect to SE traded securities. Pursuant to both no-action letters, SE market makers may disseminate quotations, without themselves registering with the Commission. Both letters, however, expressly exclude from the scope of permissible activity direct solicitation of customers in the United States and provision of analytic or research reports, through any medium, to United States investors. Both no-action positions terminate on a specific date and are subject to reexamination by the Division.

In addition, the Commission has granted an exemption from broker-dealer registration to Vickers da Costa, Ltd., a U.K. market maker proposing to maintain continuous quotations in the United States through a U.S. registered affiliate, Vickers da Costa Securities, Inc. The exemptive order includes strict limitations on the nature and extent of securities activity in which the U.K. entity may engage in the United States. The exemptive order also conditions the United States affiliate's interaction with the U.K. affiliate and imposes conditions on the United States broker-dealer to ensure that all United States customers are adequately protected in transactions that involve the U.K. affiliate.

Discussion Questions

- Should foreign market makers that limit their contacts in the United States to disseminating quotations through established market systems be required to register with the Commission, or would a conditional no-action letter based on strict limitations on the nature and extent of the foreign entities' activities be sufficient to safeguard the interests of U.S. investors who choose to use the market makers' services?

- Should foreign market makers be permitted to provide research or investment reports in the United States in addition to their quotations through established market systems without registering as broker-dealers?

  a) If customers are not solicited?
  b) If individual customers are indirectly solicited?
  c) If individual customers are directly solicited?
  d) If the research is disseminated by a U.S. broker-dealer affiliate?

- Should foreign market makers be permitted to deal with United States investors if all U.S. transactions are routed through a registered U.S. broker-dealer? In particular, should the foreign broker-dealer have access to U.S. customers if representatives of the U.S. broker-dealer are present at all conversations and all U.S. investors are customers of the U.S. broker-dealer?

- Should the Commission consider moving toward a concept of reciprocity in evaluating no-action or exemptive requests?

- Should the Commission consider the propriety of negotiating reciprocity agreements or assessing the equivalency of regulation in the area of broker-dealer registration?

- Given the difficulties of obtaining legal jurisdiction over foreign entities, should obtaining this jurisdiction on behalf of the Commission and U.S. investors be a consideration in granting foreign broker-dealers relief from U.S. registration requirements?

Attachment: Division of Enforcement Memorandum on Information Sharing Agreements

MEMORANDUM

February 6, 1987

TO: Chairman Shad

FROM: Gary Lynch
Director, Division of Enforcement

Michael D. Mann
Chief, Office of International Legal Assistance
Division of Enforcement

RE: Roundtable Briefing Paper relating to Commission Efforts to Negotiate Information Sharing Agreements

This memorandum describes the various agreements which the SEC has available, or which are currently under negotiation, to obtain evidence from abroad as well as other multilateral initiatives which the SEC has underway.

I. Bilateral Agreements for Information Sharing

A. Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the U.K. Department of Trade and Industry

On September 23, 1986, the SEC and CFTC signed a Memorandum of Understanding ("MOU") with the United Kingdom Department of Trade and Industry ("DTI"). The MOU provides, on a reciprocal basis, the SEC and the DTI with assistance in obtaining records which are in the hands of the other or which can be obtained through voluntary cooperation. It is an interim arrangement which both parties see as a first step in their efforts to establish a comprehensive understanding to provide bilateral cooperation relating to securities regulation.

The MOU is available for use in investigations and regular market oversight. Specifically, the MOU makes assistance available in matters involving insider trading, market manipulation and misrepresentations relating to market transactions as well as in efforts relating to the oversight of the operation and financial qualifications of investment businesses and brokerage firms. The MOU will provide the CFTC with similar assistance.

The SEC and the DTI have already had numerous occasions to utilize the MOU.

B. Memorandum Between the U.S. Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance

The SEC has also signed a memorandum with the Securities Bureau of the Japanese Ministry of Finance concerning the exchange of information relating to securities regulation and enforcement. In that Memorandum, signed on May 23, 1986, the agencies "agreed to facilitate each agency's respective requests for surveillance and investigatory information on a case-by-case basis." The Memorandum appointed a specific contact person in each agency to enhance regular communication and processing of requests. While the Memorandum is less specific than the MOU with the DTI, the SEC has used it to obtain information and is pleased with its operation.

C. Memorandum of Understanding Between the United States and Switzerland

On August 31, 1982, the governments of the United States and Switzerland signed a Memorandum of Understanding to establish "mutually acceptable means" for dealing with the problems of insider trading. The MOU mandates the establishment of a provisional arrangement for providing the Commission with assistance in the form of a separate private agreement among members of the Swiss Bankers' Association ("SBA"). That agreement, known as Convention XVI (the "Convention"), Convention XVI applies to insider trading which has occurred prior to announcement of an "acquisition" or "business combination," as those terms are defined in the agreement. The Convention requires the board of directors of the SBA to appoint a Commission of Inquiry to handle requests by the SEC. If the Commission of Inquiry is satisfied that the SEC has met certain thresholds set out by the Convention, the Commission of Inquiry will call for a report from the banks involved concerning the transactions covered by the request. Further, upon receipt of the request from the Commission of Inquiry, the bank will freeze the relevant customers' accounts up to the amount of the profit realized in the transaction. This assures that the funds at issue cannot be dissipated or secreted pending resolution of a case.

Convention XVI has been used successfully by the SEC. The SEC brought the first case based upon information received pursuant to the Convention in August 1986.

D. Treaty Between the U.S. and Switzerland on Mutual Assistance in Criminal Matters

The United States also has entered into a treaty with Switzerland which provides for broad assistance in the exchange of information in criminal matters. The Treaty provides assistance for cases where the alleged violations would violate the criminal laws of both countries. It is available to the SEC because the U.S. securities laws provide for criminal penalties. The Treaty applies to both court proceedings and ancillary civil proceedings; the SEC thus may make use of its provisions during investigations into conduct which might constitute a criminal offense under the securities laws.

The SEC's experience with the Treaty has been limited because of the lack of dual criminality between the U.S. securities laws and the Swiss Penal Code. However, in several recent cases the SEC has been successful in obtaining information under the Treaty which otherwise would not have been available. Further, the Swiss Parliament is in the last stages of considering legislation which would make insider trading a criminal offense and, as a result, expand the applicability of the Treaty to SEC requests.

E. Exchange of Correspondence with Ontario Securities Commission relating to mutual assistance

On September 24, 1985, the Ontario Securities Commission ("OSE") and the SEC agreed, in an exchange of letters, to assist each other in investigations and oversight of the U.S. and Toronto markets. The letters were exchanged in anticipation of the electronic trading linkage of the American Stock Exchange and the Toronto Stock Exchange. The OSC letter provided formal assurances that it is "extremely unlikely" that the Canadian blocking statute will ever be invoked to block cooperation with a SEC investigation. The SEC and the OSC regularly provide each other with the types of assistance contemplated in the exchange of correspondence.

F. Treaties with the Cayman Island and Canada on Mutual Assistance in Criminal Matters

On March 17, 1985, the U.S. and Canada signed a treaty which provides mutual assistance in criminal matters, specifically including securities matters. On July 3, 1986, the U.S. and the Cayman Islands also signed a treaty on mutual assistance which provides assistance in matters relating to insider trading and

securities fraud. 1/ The SEC believes that upon ratification, it will be able to utilize both agreements to obtain evidence from these countries.

G. Other Mutual Assistance Agreements

The United States also has agreements with the Kingdom of the Netherlands, entered into force in August 1983, Turkey, entered into force in June 1979, and Italy, entered into force in November 1985. To date the SEC has not made requests for assistance under these agreements.

II. Multilateral Efforts

A. Discussions at the Organization for Economic Cooperation and Development

The SEC has also been a participant in discussions at the Organization for Economic Development ("OECD") relating to international evidence gathering. In September 1985 the SEC proposed that the OECD Working Group on International Investment Policies of the Committee on International Investment and Multinational Enterprises initiate a survey of all Member countries concerning mutual assistance and cooperation in securities enforcement matters. The first phase of this program, the circulation of a questionnaire, is currently under way.

B. Participation in the International Organization of Securities Commissions ("IOSC")

The IOSC was established over eleven years ago as the Inter-American Association of Securities Commissions and Similar Organizations. In an effort to facilitate discussion among a broader base of securities regulators, the Organization has expanded its membership to include 30 regulatory organizations from all over the world. The SEC is an active participicant in the organization since its inception and currently serves as a member of its Executive Committee. At its July 1986 meeting, multinational committees were formed to accelerate international cooperation on enforcement and other matters. The SEC chairs the IOSC working group on the exchange of enforcement information.

1/ Indeed, the schedule of covered offenses includes a definition of fraud which is akin to 10b-5 under the Exchange Act.

C. Accord on Cooperation among IOSC Membership -- Using the US/Japan Agreement as a Model

In November 1986 the Executive Committee of the International Organization of Securities Commissions adopted a SEC proposal relating to cooperation among securities commissions. That resolution provides that each member commission provide other members with assistance, to the extent permitted by law and on a reciprocal basis, in obtaining information related to market oversight and protection of each nation's markets against fraudulent securities transactions. The resolution also requires each member to designate a contact person(s) who will insure the timely processing of all requests for assistance. The resolution has now been submitted to the membership for consideration.

Attachment B

KENNETH R. LEIBLER
PRESIDENT AND CHIEF OPERATING OFFICER
AMERICAN STOCK EXCHANGE, INC.

February 17, 1987

INTERNATIONAL SURVEILLANCE INFORMATION SHARING ARRANGEMENTS

The development of trans-national capital markets accelerates with each passing day. This trend should be encouraged, moreover, as it promises great benefits for the economies of all nations in the form of truly competitive, low cost financing for governments and private businesses. Among the critical factors hastening the development of these international securities markets are technological advances that provide investors with immediate access to all markets, increased investor sophistication and demand for performance, and a trend toward deregulation and change in many countries.[1/]

The American Stock Exchange actively encourages the development of international securities markets. To this end, the Exchange established the first two-way order flow link between a primary U.S. securities market and a primary foreign market, the Amex-Toronto Stock Exchange link. This link currently permits two-way trading in dually traded equity issues. Quotes for linked stocks are displayed on each floor, and orders are transmitted between exchanges via automated

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1/ Examples of change in foreign markets affecting internationalization include "Big Bang" in the U.K., and the admission of U.S. firms to membership in the Tokyo Stock Exchange.

routing systems. Ultimately, the link may provide participants with two-way access to all Amex or TSE stocks and options. In addition, the Amex is negotiating a licensing agreement with the European Options Exchange that will permit the EOE to trade the Exchange's XMI option during European market hours. The options traded pursuant to this agreement would be fungible; thus positions opened on one exchange could be closed on the other.

The American Stock Exchange views the internationalization of securities markets as a favorable development and it intends further initiatives in this area. Nevertheless, the Amex also shares the Commission's concern that the emerging international markets should be fair, efficient and accessible to all investors. This meeting, therefore, provides a welcome opportunity to discuss the actions that might be taken to ensure the fairness of the international markets, and most particularly, those steps that might be taken to ensure the timely exchange of essential surveillance information. In this connection, I would like to discuss the Exchange's experiences in obtaining and sharing surveillance data with foreign market places.

Our dealings with foreign markets have shown that they are willing to routinely share most of the information that one needs for successful market surveillance. This "easily available" information includes the following trade details: time, size, quote, price, executing broker, contra-broker,

clearing member identity and account type.[2/] We have found, however, that difficulties in developing information sharing arrangements typically arise over the disclosure of customer identity and customer background information. Generally, the reluctance by foreign markets to agree to the disclosure of customer information is rooted in cultural traditions reinforced by secrecy laws and blocking statutes[3/]. In jurisdictions, however, which share a common legal and cultural background with the U.S. and have history of cooperation between regulators, it is relatively easy to negotiate information sharing arrangements that contemplate the exchange of customer information.

For example, the Amex-TSE Linkage Plan provides that the exchanges will cooperate fully in investigating any trades effected through the link even though Canada has a blocking statute.[4/] The Plan further requires each exchange to use its "best efforts" to obtain relevant information from its members and share this information with the other exchange. Of

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2/ "Account type" data indicates whether a trade was executed for the account of a broker-dealer, the account of a market-maker or a public customer's account.

3/ Secrecy laws typically provide for confidentiality of bank records. They protect private interests and, therefore, may be waived with the express or implied consent of the customer. Blocking statutes, on the other hand, generally prohibit the disclosure of documents in the enacting state pursuant to a request by foreign authorities. Blocking statutes protect the sovereign interests of the enacting state and, therefore, cannot be waived by an individual.

4/ The Foreign Extraterritorial Measures Act.

crucial importance, the Ontario Securities Commission advised the SEC in writing during the approval of the Amex-TSE link that it was extremely unlikely that Canada's blocking statute would be invoked to halt an exchange of information (including an exchange of customer information) pursuant to the Linkage Plan.[5/] At present, the Amex and the TSE routinely assist one another's investigations by obtaining relevant information from their members and forwarding it to the requesting exchange. In addition, the Amex and TSE surveillance departments routinely advise one another of transactions effected through the link.

In jurisdictions that do not have a common cultural or legal heritage, however, there is concern that confidential customer information will be used by governmental bodies for other than surveillance purposes if routinely exchanged between market places or regulators. Hence, there is a good faith reluctance to enter into information sharing agreements that contemplate the disclosure of customer information. The difficulties in developing information sharing arrangements with such jurisdictions are compounded by the fact that certain activities which are considered illegal in the U.S., might be tolerated in the foreign jurisdiction. A clear example of this is insider trading.

5/ Letter dated September 24, 1985, from Ermanno Pascutto, Director, Ontario Securities Commission to Richard Ketchum, Director, Division of Market Regulation, and Gary Lynch, Director, Division of Enforcement, U.S. Securities and Exchange Commission.

In negotiating with the EOE, the Exchange encountered some difficulties in securing an information sharing arrangement that contemplates the exchange of customer data. As might be expected, these difficulties arose from the presence of EOE rules and Dutch laws that protect the privacy of customer financial information. Two important points, however, must be made about this situation which have applicability beyond the scope of the XMI licensing arrangement.

First, the EOE was willing from the outset to share basic trading information such as time, size, quote, executing broker, clearing firm and account type. This information, moreover, is the key ingredient to conducting an appropriate surveillance program.

Second, the Amex believes that arrangements can be worked out on a case by case basis with foreign markets to ensure the release of customer information. For example, on February 11, 1987, the Governing Council of the EOE approved changes to the EOE's rules which will obligate its members to provide the EOE with information regarding XMI transactions, and authorize the sharing of this information with the Amex. Further, the EOE's options disclosure statement and customer account agreement will be amended to permit the disclosure of otherwise confidential customer information to the EOE and other regulators responsible for reviewing trading in XMI options.

As can be seen, there is no single solution to the problems that arise in developing information sharing arrangements. Each agreement must be tailored to the unique characteristics of the particular jurisdictions involved. The paramount objective, of course, is protecting U.S. investors and preserving the integrity of our markets. However, an over exacting application of every U.S. regulatory standard to arrangements with foreign markets may be counter-productive. For example, such action may offend other nations who might view it as an insult to their sovereignty. Thus regulatory cooperation actually is inhibited. In addition, insistence upon overly stringent information sharing arrangements can frustrate otherwise desirable linkages, thereby placing our markets at a competitive disadvantage to foreign markets. It will not advance U.S. regulatory or economic interests if, for example, foreign markets develop in domestic securities without opportunities for our markets to participate via linkages. U.S. markets and regulators, therefore, must be sensitive to the legal and regulatory environments of other countries in arranging information sharing agreements.

The Exchange believes that there are a number of actions that domestic regulators, market places, and industry professionals might take to develop arrangements for the international sharing of surveillance information. This, in turn, will foster the growth of fair, efficient and accessible international securities markets.

First, U.S. regulators and industry professionals should meet with foreign authorities to encourage the development of common standards of conduct, such as a common view that insider trading is improper.

Second, the SEC should continue with its noteworthy efforts to negotiate information sharing arrangements with foreign authorities such as the understandings it has concluded with Canada, Switzerland, Japan and the U.K.

Third, the domestic securities markets should continue to establish trading linkage agreements with foreign markets that provide for information sharing sufficient to satisfy fundamental regulatory needs. Finally, U.S. securities markets should encourage foreign markets to participate in the Intermarket Surveillance Group.[6/] In the alternative, an "International ISG" might be established. Either development would greatly facilitate the routine exchange of international market surveillance data.

6/ The Intermarket Surveillance Group ("ISG") is an organization of eight domestic securities markets. It provides for the daily exchange of surveillance information regarding intermarket trading and it coordinates the conduct of investigations of possible intermarket trading abuses. In this connection, it should be noted that two future markets participate in ISG matters regarding intermarket trading in stock index products and the underlying securities.

SECURITIES AND EXCHANGE COMMISSION

Internationalization Roundtable

February 17, 1987

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Opening Remarks of James M. Davin*/

Some time ago an economist sent me a copy of "The Stock Exchange as an International Market." It is a fascinating study. Starting with the theory of "the inherent tendencies of markets to develop a closer intercommunication, and finally centralization in single great markets," the author enthusiastically traced the development of international markets.

"In the beginning, prices for the same American security in New York and London varied considerably and were established principally by local conditions," wrote the author, J. Edward Meeker, then an economist for the New York Stock Exchange. Soon, he explained, developments in arbitrage kept the domestic and foreign prices for American "international"

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*/ James M. Davin is appearing on behalf of the National Association of Securities Dealers, Inc. He is a member of the Board of Governors of the NASD and the NASD's 1987 Vice-Chairman, Finance and a Managing Director of The First Boston Corporation.

securities much closer together than ever before, and these issues enjoyed a much broader market.

"Few features of Wall Street life so irresistibly appeal to the imagination as this extraordinary business, conducted in the various world markets over the flashing cables with a speed vastly more rapid than the roll of the earth. . . America today enters this future period of international financial pre-eminence with a confidence for the future grounded firmly in the achievements of the present," the author concluded.

The year of this study's publication was 1922. The growth and development in arbitrage refers to information transfer - at first by sailing packet ship, then steam navigation, and ultimately by the trans-Atlantic telegraph cable.

About a hundred years earlier, the House of Rothschild reportedly made a fortune by arranging for the results of the Battle of Waterloo to be sent to its trading rooms by carrier pigeon. Some 50 years later, a German named Reuters founded a great news (and ultimately information) network using the same technology - the carrier pigeon.

Have we been here before? For those of us who will listen, history does indeed teach lessons. International investing is more than a current fad; it has been going on for centuries. Dr. Meeker was right; markets do tend to centralize; there is simply no rule that this phenomenon has to occur in one physical location. And in general, the common wisdom of these visionaries is clear; the future has always blossomed from the technologies of the present.

Change is as much a constant in modern securities markets as it was 50 or 60 years ago, but the key difference is its rate of speed.

Certainly London markets accomplished more in 1986 than could have been imagined possible in a decade not too long ago. And it seems as if the modern media won't let us forget.

What we are seeing is a unique confluence of investors, issuers and securities firms at a unique moment of time - the present - in the development of a true Global Equity Market.

It is now only a matter of time before investors worldwide will be able to purchase or sell thousands of quality equity securities from the industrialized nations literally around the clock. Investors today are searching for promising opportunities in the securities of companies located throughout

the world. This is due in large part to the investment performance in world markets during the period 1975 - 1985 with the Japanese Stock Market up 373 percent, the French 324 percent, Canada 257 percent, Germany 246 percent, U.K. 237 percent and the Standard and Poor's Composite for the U.S. up only 134 percent. Interestingly, the NASDAQ market was up 319 percent during this same period.

The worldwide tendency toward institutionalization of equity investment, coupled with a worldwide hunger for positive performance, has propelled investors into global markets.

Along with a desire for performance, investors have sought global markets for both currency and company diversification. Broader selection should, as the theory goes, produce less risk and better results. How can an investor ignore some of the world's largest food companies, defense contractors, chemical companies, technology or pharmaceutical companies? With less than a truly global perspective, an investor does. For example, as a fiduciary, would you encourage your funds manager to limit the stocks to be included in the automobile weighting of your portfolio to just Ford, General Motors and Chrysler . . . or to just Toyota, Honda and Nissan . . . or to just Jaguar or Volvo . . . or to just BMW and Mercedes? Or would you expect and encourage your funds manager to examine the entire universe before selecting those stocks that genuinely represent the best investment?

Global management is finding willing support among many pension sponsors, who in 1986 controlled some $1.6 trillion of U.S. pension assets. In many cases, we are finding these funds increasingly controlled by a new kind of chief financial officer in the U.S. - in many cases, one with significant experience in the company's overseas operation and no small degree of sophistication in non-U.S. currencies and investments. For the new kind of CFO and others, this accelerating move into global equities from pure common stock investment into bonds in the 1960s; real estate and sometimes precious metals in the 1970s; and now to global markets for the 1980s and likely into the early 1990s.

The Global Equity Market is also under way because many issuer companies are scouring the world for the least expensive capital. Today, when raising debt capital, most issuers automatically compare structures, rates, size and costs in financial centers around the world, and the same process has started in the equity markets. One of my associates, Hans-Joerg Rudloff, the Deputy Chairman of Credit Suisse First Boston, has gone so far as to say: "Today, any company that does not search for capital worldwide is likely guilty of negligence." By reaching into the entire pool of equity capital worldwide, issuers ultimately assure themselves of a better offering price and broader shareholder base.

In view of investor and issuer demand, securities firms are competing for the new international business. Already, U.S. firms have over 250 branches in 30 foreign countries, exclusive of Canada and Mexico, while some 150 foreign firms have established branches in the U.S. Some 15 to 20 global firms already operate their own worldwide communications and distribution networks; their average capitalization is $2 billion; among them, the four top Japanese firms together in 1985 equaled the total profits of all New York Stock Exchange member firms combined.

Seeing these developments, the equity markets of the world are responding: linkages between national markets are being forged; private vendor organizations are speeding the international flow of market information; and more efficient and less costly methods of clearance and settlement of international trades are being developed.

Although problems remain to be addressed, as evidenced by our attempt today to explore a number of relevant issues, the first steps toward efficient international market linkage are now being taken. A case in point is the NASD's linkage with London's International Stock Exchange introduced almost one year ago.

The New London Bridge, as it has come to be known, commenced operation on April 22, 1986, (even before Big Bang Day) with the first intercontinental market-to-market linkage, between London's SEAQ computer system and the NASDAQ system. This linkage has provided the capability of displaying live market maker quotations on some 300 NASDAQ securities on approximately 8,000 dealer terminals in the U.K. Likewise, quotes on an equal number of listed U.K. issues and London traded international issues are being displayed on 3,000 NASDAQ Level 2/3 terminals in the U.S.

We believe that the NASDAQ-London link is an extremely important step in the evolution of international equity trading. It has been extremely well received and promises to provide the catalyst for the development of true regulatory cooperation. In the future, expansion of the NASDAQ-London link is planned to include transaction information and the automated execution of intercontinental trades. In addition, a number of specific regulatory initiatives have been identified for development by the two markets which I shall address in a moment.

The ironic disappointment that the NASD and London have experienced thus far is the very tentative acceptance this pilot linkage has received from the Commission. Quite frankly, we had expected that the Commission would strongly favor the operation of international intermarket linkages. Thus far, the Commission

has been unwilling to approve the operation of the linkage for a full pilot period of two years, which we believe is the minimum duration for experimental operation of a system such as this to justify the expenditure of manpower, resources and commitment needed to bring the intended scope of the linkage to fruition.

The unfortunate aspect of this situation is that the consideration of the Pilot Program has been, and remains, bogged down in the consideration of a rate matter - namely whether the Pilot Program competitively impacts independent vendors because information on the linked securities is being exchanged between London and the NASD without charge. The concern has been that these vendors will not be able to compete for subscribers if the NASD is receiving and giving this information away for free.

This approach places the proverbial cart before the horse by elevating the protection of vendors above the development of an efficient, linked international market. The inability of two marketplaces to exchange information without charge for use within those markets because of Commission action may be viewed in other parts of the world as an unwarranted intrusion into the internal business aspects of a foreign exchange rather than an exercise of its concern with respect to regulation and investor protection.

The Pilot Program is not an initiative to create a new business opportunity for the NASD or its subsidiaries as an information supplier, rather, it is intended to create new business opportunitites for the market makers and dealers generally, which comprise the marketplace for the securities included in the link. These opportunities will be expanded to include additional information, and efficient systems for the routing to, or automatic execution of, an order in the best market. The provision of this execution and delivery system and the development and the increased efficiency and integrity of each marketplace should be the ultimate goal of this Commission. The potential for these new opportunities can only evolve if the Pilot Program is permitted to operate without unneccessary constraints benefitting interests other than the markets responsible for their development.

What is needed from the Commission is its support for programs such as these, together with their continuing participation in the structuring of these linkages to achieve longer term goals for our industry. This does not require the Commission to choose between the interest of the marketplace and the vendor because their two interests remain fully compatible.

The marketplace will benefit in the future from the broadest possible dissemination of information on the international securities eligible for inclusion in the link. The worldwide dissemination of this information will be provided by the independent information vendor and not the NASD. During the course of the Pilot Program the NASD is proposing that the information exchange be limited to the provision of information on securities included in the link by the NASD only on the Level 3 terminals at firms making markets in one or more of the linked securities that have market in both systems. At present, only 50 securities have market makers that would qualify to receive the information on these 300 additional Exchange traded securities through NASDAQ without imposition of a surcharge. Hopefully, the number of securities quoted in both systems will increase from the present group of 50 as participation in the Pilot Program expands. The NASD hopes that the Commission will be able to approve the operation of the Pilot Program on this basis for the full two year period requested in our filing.

If authorized to proceed with the Pilot Program, a number of important developments will be pursued by the NASD. The first order of business will be the modification of the NASDAQ system to receive and process transaction information on the most heavily traded U.K. issues. This transactional information will be disseminated to the same market making firms that receive the London quotation information. More importantly,

however, this transaction information is needed for inclusion in the regulatory database maintained for market surveillance purposes. The NASD intends to include this information together with quotation information in its Equity Audit Trail. We would also anticipate the eventual inclusion of clearing data on transactions in securities in the link directly into the Equity Audit Trail. Efforts will be made in the near future to coordinate this effort with the International Securities Clearing Corporation.

We would propose that information comparable to the Equity Audit Trail information on NASDAQ securities, developed for use by the Market Surveillance Department, also be furnished to London in either a pre-formatted display or by way of a continuous data stream. This will provide them with a complete audit trail of relevant data applicable to quotations and transactions in NASDAQ securities included in the linkage. In the event that additional information may be required by London, the NASD would undertake to make available the full range of its Market Surveillance resources in order to provide the Exchange staff with information they deem relevant to the completion of their investigatory effort.

Discussion of joint regulatory initiatives has been assigned a high priority by both the NASD and Exchange, and is expected to result in a number of specific programs being

undertaken during the course of the Pilot Program. These undertakings will be in addition to the excellent continuing cooperation now experienced between the marketplaces. For example, the regulatory assistance of the NASD was recently offered to the Exchange in connection with the trading of Guinness in the U.S. which was the subject of investigation in the U.K. The Exchange has taken the same approach with respect to the NASD.

Finally, a number of system approaches to the routing and automated execution of transactions will be developed for joint consideration by the NASD and Exchange and for presentation to the Commission. The ultimate goal will be to link all market makers in the linkage and assure the execution of a particular transaction in the market that provides the best execution at any particular point in time. We believe that the developments and initiatives embodied in the Pilot Program will significantly advance the process of internationalization and encourage its approval by the Commission.

* * * * *

The benefits of internationalization of existing markets are far-reaching and profound. Ultimately as Chairman Shad noted in his comments accompanying the Commission's October 9, 1986 Report to Congress, "As our worldwide economic interests

and dependencies are more closely bound together, all mankind will enjoy greater peace, prosperity and opportunity."

The more immediate practical benefits include greater liquidity for investors worldwide, more competitive access to capital and capital markets by issuers worldwide and the dissemination of securities information from major markets on a worldwide basis.

The pitfalls of the internationalization process that we face that can be avoided are:

1) The failure to formalize the exchange of information among marketplaces and regulators in the forum and manner evident today.

2) The failure to vigorously encourage the effort and commitment needed to develop a globally linked delivery system to accommodate the rapidly growing global marketplace.

3) The premature or piecemeal initiation of rule making in the absence of substantive experience with international trading linkages which could result in such marketmaking activities being driven underground or otherwise placed beyond the purview of established regulatory authorities.

4) Finally, a regulatory viewpoint that does not recognize the vast cultural differences existing throughout the world and the ever present diversity between unsophisticated individual and institutional investors.

In sum, we strongly urge the Commission to approve the operation of the Pilot Program between NASDAQ and SEAQ for a full two year period of time. Such a laboratory experiment will

provide the Commission with specific evidence concerning the appropriateness of future rulemakings, the identification of verifiable problem areas to be examined and addressed by such rulemakings, and the exposure of the Commission to practical operating experience in this area. The experience to be gained by the Commission will include order routing mechanisms, automatic execution facilities and the creation of international databases of information for surveillance purposes.

U.S. Securities and Exchange Commission Roundtable On The Internationalization of Securities Markets

The Toronto Stock Exchange

17 February 1987
Donald R. Unruh
Vice-President
International Markets

1987 is the tenth year of operation of the Toronto Stock Exchange's Computer Assisted Trading System ("CATS"). CATS is a fully automated upstairs market with a public central limit order book for each of the 800 stocks it trades. CATS stocks are not traded on the floor. Unlike the more traditional upstairs markets, CATS guarantees the price and time priority of orders absolutely. It is a visible market with transparent pricing. Like other upstairs markets, the average size of a CATS trade in an active stock appears to be more than double the average size of a floor trade in an active stock. CATS trader productivity has been independently measured at 2.75 times that on the floor. At present, there are no Specialists in either market, but rather market-makers acting as both agents and principals. In summary, CATS offers the advantages of an upstairs market and few, if any, of the disadvantages. This is the background and perspective from which I will table my comments on international market linkage.

The first question that comes to mind is the role of dealer markets in the developing global market structure. It is not a question of upstairs versus floor markets - I have addressed that: upstairs seems to be better - but rather, it is a question of quote driven versus order driven trading systems. Distributed dealer networks versus central limit order books. Principal trading, and capital, versus concentrated agency order flow. In a TSE survey of 15 of the world's biggest trading houses, 73% of the firms said that quote-driven telephone-based markets would prevail for international block trading, representing the bulk of the business. Is this view justified?

To answer the question, we constructed computerized simulation models of the NASDAQ, New York and Toronto markets. The only accurate source of systematic book and order flow data proved to be the TSE CATS system. Using this data, our models showed that, if the London dealer market aimed to match New York's trading spreads, it would need roughly three times New York's trading capital. Our best estimate today is that London has achieved about two and a half times New York's trading capital, with a mean spread in its Alpha stocks that is only 0.2% higher than that on the NYSE. While some of our information is tentative and requires more rigorous treatment, we have gained what we feel are some persuasive insights into dealer markets and linked exchange markets.

Dealer markets operate like a loosely coupled network of stock exchanges with quotation traffic in "interlisted" issues among them. The market-maker receives primary order flow from his own population of customers; and typically executes it at the best price established by the market-makers who are quoting reliably at the time. Public order flow does not interact across "markets". At the risk of greatly oversimplifying things, the same model could be applied to a global network of stock exchanges structured like dealers. A core group of international stocks could be interlisted in all markets. The total size at the best bid/ask prices in each centre would combine to form the quotation montage. The critical element of real-time information is either already available or can be provided through existing communications technology. While this is an appealing alternative, we believe that structural problems, similar to those found in dealer markets, would increase global risk.

Dealer markets are significantly more capital intensive than central limit order book markets at competitive spreads *for the same order flow*. They are, therefore, less capital efficient. However, our models have demonstrated that they rapidly become more capital efficient, and exponentially more profitable, as spreads widen. As a result, they can attract large amounts of trading capital. In a quotation-linked exchange network, the dissemination of quotations will make the markets more competitive, spreads will then narrow, the trading intermediaries will use larger amounts of their own capital - and will be exposed to increasing risks for decreasing returns. In our view, such markets could potentially become unstable. They would be at an aggregate risk equal to the risk of the weakest market.

Exchange trading linkages, such as those between the TSE and the AMEX and Midwest Stock Exchanges, improve upon the model. The quotations used by both markets are, in fact, executable orders. But they are market or marketable orders, not limit orders. Real size cannot be effectively handled, since the quotations are typically set by smaller orders. They do not reflect prices for institutional blocks, which have larger inventory carrying costs, increased market risk, and wider spreads. At this size, only access to the limit order book can provide the size and price range for institutional trading. Since international trading is 80% to 90% institutional, *market order* linkages restrict the amount of business that can be done.

Finally, we have the alternative of book-based market linkage. In its simplest form, this could be based on bilateral agreements stipulating that orders must be routed to the home market of the security traded. The information in the book would be available, but in an anonymous form showing only the volume aggregated at each price interval. This would maximize the capital efficiency of the global market for the stock. It would provide uniform disclosure of market conditions to all trading centres, and permit instant and effective regulatory action on trading. It would concentrate liquidity in the biggest book, thereby speeding up the process of price discovery, providing best prices to all users of the market.

While further work is indicated, our preliminary models suggest that such a trading system with four markets, each interacting equally with the central limit order book, would require two thirds of the capital of a Specialist system - and would have a slightly better overall performance. The technology required to implement this system is currently available. We have already licensed and installed it in the Paris Bourse. In the next few years there will be numerous suppliers of such systems. What is required is the will to use it in this manner, which already exists in some markets.

INTERNATIONAL MARKET LINKAGE
New York
21 October 1986

by
Donald R. Unruh
Vice-President
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The Toronto Stock Exchange

Introduction

When the *International Federation of Stock Exchanges* held its 1986 annual conference in New York in June, hosted by the New York Stock Exchange, I had the opportunity to chair a working session on market linkage. In it the views of stock exchanges from some 22 different countries were represented. We reviewed several kinds of market linkage, together with various solutions to international settlement problems, and some innovative trading systems - each intended to address a piece of the puzzle in the emerging global market. Before talking about alternatives for linking the markets, what I would like to do first is to try to envisage the whole market. Who the players are. What their needs are. And how fast and how far it's moving.

The international market exists only because a demand for it exists. Communications technology has stimulated an increasing demand for international equities. The price of the technology is high - a typical international dealing position today costs $100,000. In fact, over $1 billion has been spent on dealing facilities in London alone over the past 2 1/2 years. Evidently someone is willing to pay it in order to satisfy a still greater need. Today, it is the fund managers who feel the need to diversify internationally and are paying for it, largely in commissions and dealing costs. In the U.S., for example, the ERISA rules governing the treatment of pension funds are now interpreted so that fund managers who do not invest in foreign securities might be in breach of their fiduciary duty. However, the costs of international dealing are now thought to be too high, since about 65% of the Top tier investing institutions are either dealing directly for themselves or will be by the end of this year.

Tomorrow, it is the members of our stock exchanges who will pay. They will pay with reduced commissions, tighter dealing spreads, and the bundling of more costly facilities into basic services. This will be the

result of intense competition among financial intermediaries together with direct dealing by up to three quarters of the bigger institutions. They will pay willingly because principal trading in upstairs markets will operate on spreads so thin, on a capital base so big, that even second tier firms will not be able to compete, and will lose order flow to the global houses, unless they have the lowest possible trading cost. For the entire life cycle of an order - including order entry, execution, clearing and settlement.

There are many competing issues - economic, strategic, political, regulatory, technological - to name a few. But before I go on, let me first express a rather simple conclusion: In the final analysis, we are all becoming producers of a financial commodity - trade execution. And in commodity markets, the economic law is that the lowest cost producer wins.

I have just stated my view of the basic problem. Let me now tell you how I arrived at this conclusion, and then how it leads to a model for linking the markets.

Market Research

In order to get an initial understanding of the international market, we've done two major market research studies. The first is an in-depth survey of 15 global brokers and banks. The second is a survey of 20 Toronto Stock Exchange Member offices in Europe. As a result we've segmented the international market into three tiers. Both for investors and for intermediaries.

In the top tier of investors, there are 2,000 to 3,000 institutions that do two thirds to three quarters of the world's trading and up to 90% of international trading. Their average international transaction size today is $5 million, or 20 times what it was ten years ago, and still growing. Some European institutions have a minimum order size of $10 million. 65% of them are now dealing for themselves - a condition called disintermediation. A recent survey by Greenwich Associates forecasts that this will increase to about 60% for all institutions by 1990 and 75% for the Top Tier institutions. Even some large corporations are dealing for themselves as a natural evolution of their treasury function - Mitsubishi, for example, operates a $1 billion trading fund out of London.

In the next tier, there are at least 15,000 smaller institutions and companies. Finally, there are about 110 million individual investors who, due to the recent rise in global equity markets, are growing at more than 10 million per year. Together, they account for over 25% of the world's trading.

Market intermediaries are also segmented into 3 tiers. In the top tier are 15 to 20 global firms that operate world-wide distribution and communications networks. They have an average of $2 billion in capital each. The biggest of them, at the present time, is Nomura Securities which had a profit $1.5 billion in its 1985 fiscal year. This was equal to 36% of the pre-tax net income of all Members of the New York Stock Exchange in 1985. In fact the top four Japanese houses equaled the total profits of all NYSE Members last year. The top tier is highly capital intensive - so much so that one firm in our survey thought that Goldman Sachs, with close to $1 billion in capital, would be undercapitalized in the future markets. Recent events have shown that Goldman Sachs thinks so too.

These firms are in fact markets unto themselves. The big four Japanese houses seem to have this view. They are jointly developing their own automated trading system to manage the entire life cycle of an institutional order in a factory automation type of process. Information about the project is closely held, but I was informed by one of the firms that it will be operational in a year's time. A similar thing is happening in the U.K. The largest investing institutions here told me recently that the top 4 or 5 British firms, those with their own automated dealing systems, will provide them with private quotation terminals for institutional-sized quotes and order entry - thereby bypassing the Stock Exchange's SEAQ trading system. What surprises me is not that they are doing it, but the eager acceptance by these institutions of such bypass trading facilities. The institutional customers of the biggest intermediaries are clearly prepared to go upstairs and out of exchange markets.

The second tier of intermediaries consists of 100 to 120 firms, each having $200 million or more in capital. These firms are still dependent on stock exchanges to lay off the tag ends of their business. Interestingly, the top tier firms in our survey support them since they perform the useful function of aggregating smaller orders to feed into them and of taking the tag ends of their business, in turn.

Finally, there are some 5,000 small intermediaries that are boutiques doing a specialized business, or who are regional in character.

Summarizing the role of the market intermediaries, it is clear that the Top Tier firms, who are doing a third to a half of the trading in the world, will have a major influence on the business that stock exchanges will do in the future. If not as Members, then as competitors. 55% of such firms surveyed by us do not believe that stock exchanges will have a major role in regulating the international equities market. We therefore have to ask, "How important is this market?"

We estimate that international equities trading accounted for $160 billion in turnover in 1985, counting one side only, or about 7.5% of the world equity turnover. Analyzing the simple probabilities, this means that some 14% of the volume done last year had one foreign counterparty, with the other side in the home market; and less than 1% of the volume had two foreign counterparties and was, therefore, detached from its market of domicile. If existing trends continue, then by 1990 15% of global trading will be international, amounting to about $530 billion. 28% of all trading by that time will have one foreign counterparty, and just 2% will have two foreign counterparties. This volume of trading has serious implications for clearing and settlement systems which will have to cope with more than $1 trillion of foreign equities settlement per year, counting both sides as we must.

But that's not all. It gets worse, or better, depending on whether you have to process the trades or are a trader. International equities transactions today are triggered by currency movements. In fact, many dealers hold foreign equities as a surrogate for the currency of the home market. Such transactions often result in 2 to 4 transactions in total - including a parallel currency transaction, additional transactions on the tag ends of the trades in order to balance the dealer's book, and possible further currency trades or hedging transactions against inventory. So the impact on clearing systems will be more like $2 to $4 trillion in 1990.

But that's not all. This could still be an underestimate of trading volumes. That's because we've made some conservative assumptions about the behaviour of the Japanese investor, who is now the world's biggest foreign trader, trading foreign equities at the beginning of this year at the rate of $84 billion per year, although it has moderated recently, and foreign bonds at the rate of nearly $2 trillion per year. I might add that Canada accounts for 12% of Japanese foreign debt investment and ranks

second in Japanese interest only to the U.S. If a fraction of this debt investment moves into equities, the world's equity markets will have difficulty absorbing it. In making the forecast, I have assumed that Japanese foreign equity turnover rates will be the same as domestic turnover rates. In fact, the evidence suggests that they are now 4 to 7 times higher, probably because of volatility in the Yen. If this is still true in 1990, then you can take my world forecast and double it.

So who's going to handle all this trading? The money for it is now mostly in the over-the-counter bond or money markets. In fact, the world's financial assets are now about $40 trillion, or about 8 times world equity market capitalization, and their turnover ratios are a lot higher than equities, with $40 trillion per year in foreign exchange trading alone. It's being traded upstairs by telephone by the same guys who brought you the Eurobond market in 1968 and the Euroyen market in 1984. How are they going to react when their biggest customers tell them to take their money out of bonds and put it into an equities trading account? As our market research shows, they will begin trading international equities the same way they are now trading Eurobonds.

They will probably use the same clearing service - 85% said that Euro-Clear is the most likely candidate. All of them would prefer to see a global network of linked book-based depositories with all settlement done locally by book entry, but only 14% think that this is likely, given current realities. It would be much more cost-effective to use book-based systems, particularly since Euro-Clear clears gross and does not permit the netting of obligations and, is, therefore, highly capital-intensive. In addition, equity trades can be rescinded as late as the day before settlement, thereby leading to excessive settlement fail rates. Euro-Clear's equity fail rates currently average 20%; and in other centres it can be as high as 35% to 40%. As a result, demand for the more effective book-based clearing systems will surely increase.

Of course, to be efficient they must be linked to the trading systems. To be even more efficient, I believe that these should be automated trading systems. But what do the traders say?

79% of the Top Tier houses in our sample think that telephone markets will migrate to some extent to screen trading. They feel that central limit order book trading systems, as opposed to dealer systems, will be widely used, but mainly for small orders. Only 27% felt that the upper end of the market, block trading, would be automated in any form.

In contrast with these views, the markets around the world are going in a different direction. For example, London's, or perhaps I should say the International Stock Exchange's, SEAQ system which, with its 1,000 by 1,000 size guarantee for small orders does not provide the central limit order book that is expected here. It is a dealer market in which the bigger dealers will bypass SEAQ for block trades. This only reinforces the notion that in such markets individual dealers can become the market themselves, using private quotation networks and other technologies that stock exchanges themselves would use. At the other extreme, however, the Tokyo market has deployed its CORES automated central limit order book system, currently handling very large business, trading up to a billion shares in one day.

The Top Tier firms are currently building in-house trading systems in any event, so the question might be academic, since they obviously think their business can be handled this way. Despite conflicting views, I believe that automated trading systems will prevail for all sizes of business. At the Toronto Stock Exchange, we implemented the world's first automated equities market in 1977 when we commenced trading with our CATS system. CATS is now the only place where 800 of our listed issues can trade. On June 23rd of this year, the Paris Bourse also started trading on CATS, with all trading on 18 active stocks, including such issues as Louis Vuitton which also trades in ADR form on NASDAQ, being processed in our data centre in Toronto. Within the next 60 days, the Paris system will be the only place where the Paris brokers can trade some 50 active stocks, accounting for about a quarter of Paris turnover. To position our market, CATS is bigger than Instinet, with about 450 trading terminals plus another 4,000 Member terminals making inquiries on our trading books. By the end of 1987 I expect to see 700 to 800 trading terminals in place. Counting both sides, CATS now does US$29 billion per year in trading, and by the end of this year or early next year it will be $52 billion per year.

Our own experience in Canada, and the experience so far in the Paris market, shows very clearly that exposure to the CATS trading system creates a strong base of support. And it is not small business, since the average CATS trade is 50% larger than the average floor trade. The trading volumes in the Paris system are now growing at the rate of 15% *per week* per stock. Furthermore, academic studies indicate that market quality does not suffer. Finally, I was told recently by our two largest firms that their CATS traders are making several times more money than

their floor traders - a very sound argument for increased use of automated trading systems.

I have now talked about some of our market research findings and have pointed out the very real possibility of international trading being taken upstairs by the global trading houses. Many of us are, I know, painfully aware of the effectiveness of these block traders making markets in the globally traded issues. There is no doubt that they will increasingly do so. If for no other reason than the fact that these firms are implementing proprietary trading technology which is faster, cheaper, and better than what most stock exchanges can offer.

Some people have pointed out that, in any case, their trading will flow back to the market of domicile, as the final lay off of the business, and that there's no real threat. A probability analysis of trading counterparties as shown earlier, seems to support this. There are, however, two points to consider. The first is that the flowback to the market of domicile, in the final analysis, is a function of where the shareholders are - the buyers and sellers of last resort. Today, only about 17% of the shares of the internationally traded equities are foreign owned. If this figure increases to 30% by 1990, then the probability of flowback will decrease exponentially. The second point is that share turnover ratios are much higher in international markets than in the domestic market for the same stock, largely due to currency fluctuations. In fact, today some stocks do more trading offshore than domestically, and are becoming detached from their markets of domicile. When both trading turnover and share ownership are considered in this light, we must conclude that when more than 70% of trading and between 20% and 40% of share ownership are both lost to a foreign market, it is next to impossible to get it back. A real threat does indeed exist.

International Market Linkage

The driving force behind these market trends is deregulation of the markets on a global scale. This has introduced massive dislocations of capital and, more importantly, a level of competition in the financial services sector that would have been unthinkable a few years earlier. Inevitably, some financial centres will have global ambitions, thereby putting pressure on other markets. For example, John Young, head of markets at the London Stock Exchange stated a couple of weeks ago in a private meeting that the objective of the International Stock Exchange, as

London's market is now called, is to take 10% of New York's trading volume during New York market hours, in addition to the trading gained before New York opens. This pressure for change is felt everywhere. Brokers are taking their trading to wherever they can operate free from unnecessary regulation or excessive costs. They are making markets upstairs, engaging in net dealing, committing rapidly increasing amounts of capital to bigger and more highly leveraged principal positions. Because that's what's needed to stay alive under these conditions.

The 1984 SIA delphi study on the future of the securities industry pointed out, with a broad consensus, that the survival factor for the rest of the decade is cost control. I rather like the statement made by Anthony Greayer, Deputy Chief Executive, Hoare Govett at a Euromoney conference held in January of this year: "We're going to hit a completely new game in the future. Either we're going to be acting as principal, and its only the bid/offer spread that we've got to play with in which to encompass all our costs including, critically, the cost of clearing and settlement, or we're acting as an agent and we're going to see our commissions squeezed."

Any cost squeeze on brokers will inevitably flow back to stock exchanges. Stock exchange Members will demand reductions in service fees, including the possible elimination of transaction fees from those exchanges that have them. The trading technology that is now required is expensive. However, when these trading systems are linked, either directly or indirectly through arbitrage, economic rather than technical laws will take over, and the low cost producers will prevail.

Certainly, automation reduces costs relative to what they were before. But we increasingly need to have global comparability of our costs. For example, in Toronto we did an independently audited study of our trading costs in 1984. It showed that on our trading floor our total cost per trade, one side, was 87¢. Today, our cost of doing a CATS trade is about 20¢ per side at current volumes. By comparison, the London Stock Exchange recently announced its SAEF system for automated execution of market orders to be introduced in 1987 with a reported cost of 2 pounds, or roughly $3.00 per trade per side, not including settlement. Fifteen times the cost of a visible, fully automated trade in CATS. I do not need to point out that investors can go virtually anywhere in order to obtain the lowest cost of trading, or that it is equally easy for low cost automated markets to expand to any other country and, even with the increased communications cost, be competitive.

We no longer have the monopoly that we once did in our own countries. The users of the markets in most countries have a choice now, at least for the most active stocks. Communications technology provides them with the means to take their business virtually anywhere. If we are to survive, we have to adapt to the emerging economics of global trading. To repeat what I said earlier: trading is becoming a commodity; and the economic law in commodity markets is that the lowest cost producer wins, all other things being equal.

Our institutions and corporations are increasingly deciding that securities trading is an integral component of their operations. Investment opportunities, and even the investment regulations in some countries, are forcing them to go abroad. And global communications services vendors are making it cheaper to go across the ocean than across the country. These trends are forcing stock exchanges to align themselves with the needs of their biggest players and to link to other markets in order to keep their customers. The need to link markets has never been more apparent. As Dr. Johnston said, we should all hang together, or we'll all hang separately.

Market linkage was the main subject of the *International Federation of Stock Exchanges* conference in June. In the discussions I chaired, we examined some of the implications of international market linkage, and while there was general agreement that these linkages are an important first step, the best method of linking markets could not be agreed upon at the time, although the majority of support was for the last of the alternatives that I will now describe.

- First. Passing a common order book to markets in different time zones to operate in the prime hours of each market. For example, the system used by IOCC. It was reported that only small limit orders are actually passed to other markets in this system - due to risks caused by volatility in the products traded, both for investors and for the exchanges which have to guarantee the orders sent to it, and the loss of control of positions placed in it overnight. The Montreal Exchange said that it had suffered "huge losses" because the book is not automated and trade-throughs occurred. By this I mean that only an automated book can guarantee that limit orders at a particular price will not be missed when the market moves past them. It was felt that big positions could

not be effectively managed in such a system. A further problem is that, if after-hours trading is permitted, as it is in many European markets, it will be very difficult to pass one's positions in the book to someone else while still trading.

We conclude that automation of the public limit order book is a pre-requisite to passing the book to other markets. Because only a fully automated book can guarantee the price and time priority of an order absolutely. But the corollary is that, if the book is automated, it doesn't need to be passed to other markets. It can be accessed from other time zones using computer terminals, markets can be made just as effectively, trades can be reported where they originate, and such a system is really no different than a central limit order book fixed in its market of domicile. It is only when markets prefer to use a trading floor that this kind of linkage is required.

- Second. Interlisting was considered by the Swiss to be a form of linkage in that it enables a local constituency to be built up for foreign companies. It also permits institutions, such as pension funds, which are prohibited from investing in unlisted securities to invest in them. We noted, however, that an interlisting strategy by itself is inadequate in that, except for the biggest issues, which are interlisted anyway and have a local constituency, the home market of the security will be more liquid. Any big positions traded in the foreign market would probably have to be laid off there. This implies that the foreign securities firms would also need to be Members in the home Stock Exchange of such securities. Therefore, interlisting without inter-Membership is not a effective strategy. For obvious reasons, this is not feasible on a large scale around the world at present, but will become so in the future when more open markets exist.

- Finally, we come to the alternative of providing electronic access to a single limit order book located in home market of the securities in question. This would permit the trading to always be done in the most liquid market. Although it can be argued whether this market will be any more liquid when the major users of it are at home in bed, and the trading is

being done by foreign securities firms with a small number of shareholders in their own time zone.

Analysis of this question leads to a discussion about the value of the book itself. The home market will create the deepest book of limit orders since we know that 83% of the shareholders and 92.5% of trading in internationally traded equities is there. Recent academic work amply demonstrates that the deeper the book is, the more liquid the trading in that market becomes. Therefore, we must conclude that the most liquid markets will occur when the book in the home market is accessible electronically, when, in effect, the liquidity of the home market is exported to other time zones.

Of course, this implies that the market must have an automated book and must operate it outside of its normal trading hours. Only a few Stock Exchanges can do it at the moment, but *within 5 years virtually every major exchange in the world should be in this position.*

In all cases, some form of membership in linked markets is implied, whether it is direct membership, or electronic access membership. This will, I believe, be a significant ongoing question concerning linked markets.

The issue is further complicated by competitive factors. We make the following observations based on our market research:

- The biggest trading houses in the world now do a bigger business than many national stock exchanges. Acting as principal, they can now take on a few of the internationally traded issues and break the natural pricing monopoly of the home market in all but the biggest stock exchanges. They can become *the market* for such issues. Unless we move quickly to consolidate trading in a single central limit order book in the home markets of these issues, they will not only continue as a threat but will increase. Rapidly growing global communications and trading networks will make it possible, no, probable - as recent developments in the dealer market in London demonstrate.

- International trading is stimulated by currency movements more than any other factor. Movements of 1% per day in the major currencies are now the norm. The global securities firms deal in these currencies, in size, every day - Stock Exchanges do not. The magnitude of currency movements may not be clear to everyone here. By way of example, a trade of 10,000 shares of IBM at this volatility level could change the settlement price of the transaction, when expressed in a different currency, by $12,000 per day between trade date and settlement date - and this does not include the currency conversion spread. Quotation in multiple currencies for trading equities is a pre-requisite for international stock exchange business; and efficient low cost methods of currency translation must be employed. One example is the automated currency conversion system operated by the Toronto Stock Exchange for business done across its inter-professional trading links to the AMEX and the Midwest Stock Exchange. U.S. Specialists can trade and settle Canadian stocks at the quoted Canadian dollar price in U.S. dollars without being aware of an intervening currency transaction. The importance of this feature is highlighted by the fact that, on most days, there are more currency transactions than equity trades across the links, implying that our Members are using the currency facility for their other business. A demand exists.

I believe that the long term solution is a network of markets linked to each other in such a way that only one order book exists for each stock, and is located in the home market of the stock. At the present, this is not practical for all markets due to differences in methods of trading, hours of operation, and the level of automation. However, in my opinion, that is only a question of time.

The Toronto Stock Exchange is attempting to facilitate such linkages through the sale of its CATS system and sophisticated market information systems. We are the only market in the world making our most competitive weapons available to other markets in different time zones. Our goal is to promote co-operation and market linkage rather than competition. Within the next 6 months, we expect to have deals with 3 or 4 stock exchanges in all. Why is this important?

It is important because of the way in which money is invested today. We are witnessing the rise of the global fund manager. Such managers no longer invest simply along geographic boundaries. The new boundaries are currencies, economic stability, and, most important, the ease of entry and exit, and the cost of doing business. Such managers will spend time dealing in any one market in proportion to their investment in it. The deciding factor is usually market capitalization. A 1% market share gets you 16 hours per year of his time, including his worrying over a currency whose volatility might cost more time than it's worth, and for which there are usually no hedging instruments, or over a market whose lack of depth might require months to unwind a single position.

The Top Tier houses are aligned with these fund managers. These firms are developing trading products that permit global investment on a sectoral basis. If a fund wants to invest in golds, for example, it will buy a gold index product based on, say 3 South African, 2 Canadian and 1 Australian gold shares, in the currency of its choice. This will then be executed immediately priced off a composite global market information system, as principal. The firm will then commit this transaction to its in-house trading system to be processed as a basket trade, taking into account its own positions in the currencies and issues in question, together with possible hedging using gold options or futures. No one stock exchange acting alone can do this. The Top Tier firms can beat us all with this strategy.

The solution is, as mentioned earlier, a global network of stock exchanges linked to each other, and with a single automated book for each stock in its country of domicile. As described earlier, this would provide the highest degree of liquidity for trading in those stocks. At the same time, it would reduce the threat from third party trading networks by permitting all instruments across the network of exchanges to be traded as if they were local, with greater efficiency, a higher degree of confidence, better visibility, and lower cost than the competing dealers. It would also permit the development and regulation of trading products configured across markets and across currencies. A parallel network of linked book-based clearing and depository systems is also required, if we are to be completely competitive on a speed and cost basis.

An Alternative Market

Dealer markets, such as London, do not support linkage to stock exchanges which utilize a central limit order book, for the technical and structural reasons I have explored today. Accordingly, in the *U.K. only* the Toronto Stock Exchange is adopting a radically different approach. The Board of Governors of the Toronto Stock Exchange has approved a trading plan to be put into operation on or about February 23rd, 1987, subject to obtaining any regulatory approvals that might be necessary. The plan consists of the following elements:

- U.K. investing institutions will be provided with TSE CATS trading terminals. They will have access to our order books and will be permitted to enter orders directly into our trading systems. All such orders will use the clearing number of a TSE Member. They could use a different number on every trade.

- The TSE will open its market at 9 AM London time and close it at 4 PM Toronto time for roughly 12 hours per day of trading.

- TSE and New York and NASDAQ stocks will be traded.

- Quotations will be disseminated in Pounds Sterling, U.S. Dollars, or Canadian Dollars, selected by the user of the trading terminal, at his option; and he will be able to clear and settle any single trade in any of those currencies in a manner which is virtually invisible to him.

- A parallel 5 day forward currency market will be moved into CATS; and anyone who is qualified, domestic or foreign, bank or broker, will be permitted to make a competitive market in these currencies.

- A global market information system with equities data from all Canadian and U.S. markets, the U.K. and Japan will be available on the trading terminals.

- The system will be called CATS-International.

If you have any questions concerning the matters raised in this report, I will be pleased to answer them, if possible, at this time.

"International Challenges: A National Focus"

Introductory Remarks to the

SEC Roundtable on Internationalization

February 17, 1987

by

Richard W. Myers

Senior Vice President

International Securities Clearing Corporation

Our topic today can be summarized in two words: international and national.

First of all, it is the SEC, our national regulator, and the growth of international trading which bring us here today.

More importantly, most of us are focusing on how best to support and encourage international trading in securities markets and in equity and bond issues that are still basically national in many ways.

I think that we would all acknowledge that these national aspects, or at least the lack of coordination among them, represents a serious constraint on the potential of a truly international marketplace for equities and bonds.

International dealers face challenges associated with national currency risks, time-zone disadvantages, limited market capacity, varying settlement calendars, political risks, different and sometimes restrictive regulatory and tax structures, and unfamiliar accounting standards.

Yet the most fundamental challenge is determining how, and in some cases, whether a trade, once it has been executed in another market, will be actually settled, and at what cost. As we all know, the viability of any market depends on the ability to deliver product and transfer funds in a timely and effective manner. The international trading markets are no exception.

We will hear today about the various means by which exchanges and market systems are trying to position themselves within international networks. Most are pursuing strategies that will enable them to remain competitive by providing extended trading hours, more foreign listings, expanded foreign memberships, and the ability to add innovative hybrid and derivative financial instruments that seem to crop up overnight.

With virtually every major national market focused on surviving and profiting in the new "global" order, the closer these markets are linked, the stronger will be their need for efficient, coordinated, cross-border settlement capabilities.
As the volume of trading across national borders expands, so does the risk of trading profits becoming administrative losses. The creation of a viable, international clearance and settlement system to minimize transaction costs and to accommodate high-volume trading seems to be a prerequisite to realizing the global market's potential.

Centralized clearance and settlement has proven effective in many national markets and in the Eurobond market. Yet, for international trades, the idea of constructing a single global registry for equities, which every market participant would join, represents only one theoretical solution, and in a political context, it is probably the most difficult and sophisticated.

Just as a single world currency has so far eluded the foreign exchange market, it seems that a single global clearing

approach is not a realistic short-term expectation for the world's securities markets.

Yet, many of us would favor global clearing standards, cooperatively defined, as our ultimate goal. In order to encourage that trend while serving near-term needs, the major clearing systems and depositories associated with the largest capital markets and most widely traded securities issues are slowly beginning the odyssey. We recognize that in order for our participants to be most competitive internationally, they need to be able to operate within, and not outside, the trading and clearance infrastucture of national markets.

So, market to market, one-way or reciprocally, we are beginning to structure bridges which allow our firms to pursue business opportunities in other markets and which also enable our markets to make foreign equity and bond issues available for trading locally.

At ISCC, we are the internationally-oriented component of the largest SEC-registered clearing corporation. As such, we have a stated mission which is built around supporting the international needs of US-based participants.

To date, our primary means of doing so has involved linking major clearing and depository systems with our participants. So far, we have an incoming link with The Canadian Depository for Securities Limited (CDS), and an outgoing link with the London Stock Exchange (LSE), with an incoming link from the LSE to ISCC

shortly. We are also in the process of establishing links with Cedel and Euro-clear, and through them, to national clearing and depository systems in continental Europe. Additionally, we are working with the Tokyo Stock Exchange and its clearing organization, Japan Securities Clearing Corporation (JSCC), for development of a clearing link with that very important market.

Each of these clearing links is intended to encompass central recording of trade data, an industry-accepted trade accounting method, controlled exchange of securities and funds, local custody, third-party deliveries and transfers. Each is initially based on accessing the traditional infrastructure, and tailoring it to international needs.

For example, ISCC's outbound link to the London Stock Exchange enables an ISCC participant to settle UK securities traded over-the-counter with a London Stock Exchange member firm or with another ISCC member. The ISCC participant in the US reports the trade details to ISCC using the automated format of the LSE's "bargain record" to input price, counterparty, settlement date and so on...the usual details any clearing system needs to know in order to process a trade. Transfer instructions are also input for each trade. ISCC batches together this trade data from all participants and sends it to the LSE's Checking System.

The Checking System is a comparison system. It attempts to match the purchase and sale bargain records submitted by LSE firms and by ISCC, on behalf of its participants. For each

user, including the ISCC participants, the LSE Checking System issues daily reports showing which of its trades have matched and which have not. If a trade match does not occur at first, ISCC participants can correct or cancel their input by following the same procedures as LSE members use. However, with ISCC acting as both input/concentrator and output/distributor, ISCC participants can always submit their input and receive their output locally in the US.

Matched trades are next routed to the LSE's TALISMAN settlement accounting system. Preparations begin for the eventual settlement of securities and funds, generally on the fortnightly Account Day. Daily reports from TALISMAN document the status of completed and pending settlement activity.

Several days before Account Day, in order to receive settlement funds promptly, selling firms must deposit the securities they have sold for delivery within TALISMAN. ISCC participants' shares are usually held overseas, so they generally arrange to have their UK custodians make the deposits.

Then, TALISMAN continues in its usual processing, temporarily transferring those deposited securities into its book-entry nominee, SEPON.

On Account Day, TALISMAN allocates the SEPON securities to buying firms, on a trade-for-trade basis. Then, TALISMAN automatically notifies the registrar to transfer the shares from the SEPON nominee into the purchasers' names.

While their newly purchased shares are being re-registered, ISCC participants, like LSE members, can expedite delivery-versus-payment to institutional customers by temporarily using TALISMAN Stock Notes.

Eventually, most ISCC participants' UK securities are immobilized in a London custody account or redelivered on to a third-party institutional client. In all cases, though, our goal is to keep the securities certificates in a controlled environment within the City of London.

Money settlement also occurs in London each day, in tandem with the securities movements. Each morning, ISCC pays or receives two net figures, one in British pounds sterling and one in US dollars, representing the total value of all participants' settlements. In turn, ISCC's bank in London debits or credits participants' sterling and dollar bank accounts.

The key benefit of our ISCC-LSE link is the efficient, local access gained by domestic US participants -- non-members of the LSE -- into the LSE's settlement system. By adapting to LSE's formats, ISCC participants can clear trades on a par with LSE members -- as dealers, not customers. We currently have four participants piloting this link, and four other firms are in queue.

On the other side, ISCC's inbound link with the LSE will enable the LSE members to settle trades in US issues through National Securities Clearing Corporation (NSCC) and The Depository Trust Company (DTC).

ISCC will sponsor the LSE into NSCC and DTC. To ensure that ISCC will be able to meet its obligations to NSCC and DTC, the LSE will assume the same responsibilities which ISCC assumes through the sponsorship arrangement.

Thus, the LSE will meet whatever clearing fund obligations ISCC will have in NSCC and DTC and will have the same assessment liabilities that ISCC will have to each clearing agency.

Beyond initial market-to-market links, however, ISCC believes that internationally-harmonious clearing capabilities must be developed on a global scale in order for international trading markets to continue to expand successfully.

We believe that the most productive way to navigate the channels between world's financial centers is by collaboration between industry clearing organizations representing their national constituencies' international commitment.

It was this challenge -- to represent our national participants internationally -- which prompted the creation of ISCC 15 months ago and has guided our progress to date. It will be our central topic this morning.

ROUNDTABLE ON INTERNALIZATION
February 17, 1987

Remarks of

Edward F. Greene
Cleary, Gottlieb, Steen & Hamilton
Washington, D.C.

The growth of alternative markets means choice as to the market in which to finance. At the same time, given institutional interest in diversifying investments by types of issuer, currency and country, we can expect to see growing cross border securities activity. Thus, securities distributed in one market may well trade in several markets. The rapid growth of the technology of telecommunications, the movement to book entry systems and the lack of restrictions on currency transfers makes it easy for U.S. institutions to purchase securities in all markets around the world. Moreover, whereas the international marketplace for new issues until recent years related to debt largely, international offerings of common stock now are quite common. In response to these developments, there has been an increase in U.S. institutions' and pension funds appointing non-U.S. investment advisers with discretion to invest in foreign securities.

Accompanying these trends has been a growing uncertainty among members of the securities bar as to reach of the registration provisions of the U.S. securities laws, especially with respect to:

(i) Foreign and international securities distributions which are not registered in the U.S. and

(ii) Subsequent sales into the U.S. of these securities distributed abroad.

The last time the Commission spoke in any comprehensive way was in 1964, when it issued Release 4708. That release was issued because the interest equalization tax then in effect had led to U.S. issuers selling to foreigners off shore. Questions had arisen whether use of jurisdictional means inevitably implicated the registration provisions of the 1933 Act. The questions were legitimate because the courts have interpreted the jurisdictional nexus of the acts broadly

to confer jurisdiction, especially in fraud cases, and the Commission itself had been equally expansive. The release was important, for it established the general principle that no registration would be necessary despite some use of jurisdictional means if the steps taken in the offering "are reasonably designed to make the distribution come to rest abroad." That judgment was premised on a judgment that the "registration requirements" were primarily intended to protect U.S. investors.

At time of release, the IET applied to U.S. purchasers of securities issued by non-U.S. issuers. The tax in and of itself represented a significant economic disincentive to U.S. buyers. With its effective repeal in 1974, securities lawyers' developed elaborate procedures designed to substitute for the disincentives of the tax. These procedures were developed in connection with debt offerings, and many were approved in

no-action letters. Their substance can be summarized generally as follows:

1. Invitation telexes to prospective underwriters and dealers state that the securities will not be registered and cannot be sold in U.S. or to U.S. persons.

2. Participants in distribution agree contractually not to sell to U.S. persons or residents, wherever located; foreign branches of U.S. banks, however, are allowed to buy under special procedures. [With respect to securities of the same class acquired otherwise than in connection with the distribution, agree not to sell in U.S. or to U.S. persons prior to 90 days after completion of distribution as determined by lead manager. Sales of distribution securities are accompanied by confirmations.]

3. Securities are not available in definitive form until 90 days after the lead manager declares that the distribution is complete; that is the securities are "locked up." Underwriters agree upon request to confirm to the lead that they have sold all allotted securities.

4. During the lock-up period, dealers are required to include in their confirmation notice that the securities cannot be sold to U.S. persons or residents.

5. When the lock-up expires, the beneficial holders must certify that they are not U.S. persons or residents to obtain definitive securities.

6. The offering circular describes the restrictions.

7. Press releases and tombstone advertisements state that the securities have not been registered under the 1933 Act and that they may not be sold

in the U.S. or to U.S. persons as part of the distribution. Tombstones usually not published until the closing date, or such later time as the lead managing underwriter believes the distribution to have been completed.

8. After the lock-up, the securities are generally thought to be seasoned.

Two observations about these restrictions. First, they are not territorial -- no U.S. person or resident can participate even if the offering and sale is entirely abroad. Secondly, they are of limited relevance to equity offerings, because such offerings cannot be "locked-up.".

These procedures reflect the way the Commission and the staff often makes law in new areas. First, a general release is issued; then the release is explicated in a series of no-action letters, which I would refer to as "tea-leaves." The bar then reads those tea-leaves and at times asks that more

be added to the brew to keep it strong. The result is that a lore grows up that has a life of its own. Moreover the lore spreads; indeed, we have at times seen these procedures built into dollar issues by non-U.S. issuers where there is no market at all in the U.S. for their securities and where the distribution occurs in their home market. The fear of the 1933 Act is pervasive.

This is not to denigrate the no-action letter process. It is an innovative and resilient response to the need to fill in the intertices of any statutory system. At the same time, however, one must occasionally step back and take an overview, and remember that often the procedures volunteered may go beyond what the law requires in order to obtain the letters. Indeed, in my judgment, that is what happened here and accounts for the evolution of restrictions that are not territorial.

While there are many short-comings conceptually in these procedures, I will limit my remarks to the types of offerings that should, as contemplated by Release 4708, be exempt from the 1933 Act.

- The 1933 Act requirements should apply to offers and sales in the United States and should not apply to offers and sales outside the United States, by any issuer, U.S. or non-U.S., to non-residents of the United States. U.S. citizens resident abroad should look to the protection of local law. At the same time, foreign citizens resident in the U.S. are entitled to the protection of the Securities Act.
- Corporations headquartered and primarily operating in a jurisdiction (whereever incorporated) should be treated as

residents of that jurisdiction. Foreign corporations should be treated as non-residents of the United States, even if in connection with securities transactions with such corporations there are contacts with U.S.-based officers of an affiliated corporation, unless the foreign corporation has no business purpose other than to invest in unregistered securities.

- Insurance company and bank branches operating in a jurisdiction and subject to regulation by that jurisdiction should be treated as residents of that jurisdiction (an approach reflected in the Commission's recent release on Section 3(a)(2)).

- Transactions with foreign-based investment advisers or fiduciaries should also be treated as non-resident transactions if the advisers are acting with discretion.
- But the territorial principle should not be applied inflexibly; there should be permitted variations; for example, although located in the U.S., the following entities should not be entitled to benefits of the 1933 Act.
  - i) International entities such as the UN, IMF, World Bank and their pension funds.
  - ii) International banking facilities of U.S. banks.
- At the same time, specific targeted groups of non-resident Americans, such as armed

forces personnel stationed abroad should be entitled to the benefits of the 1933 Act.

- This approach does not mean one should be insensitive to flow-back. <u>If a principal market exists</u> in the United States with respect to securities of an issuer, restrictions should be incorporated into an offering to give assurance that the distribution will come to rest abroad and is not targeted for the U.S. market. These restrictions need not be as elaborate as the staff and the bar have devised, but there should be some. In a submission to the staff, we have suggested what those might be. Moreover, with respect to restrictions, distinctions

should probably be made between debt and equity securities and between Canadian and other non-U.S. Issuers.

- However, one must recognize that with many issuers, there will be cross border trading, initiated often by U.S. investors. Some of that trading will be flowback after an offering and some of it will occur whether or not there has been a primary distribution. Flowback into the U.S. of a foreign issuers securities should not result in imposing Exchange Act reporting requirements unless that Issuer <u>voluntarily</u> offers such securities in the United States or lists such securities on an exchange. If secondary market transactions result in imposition of our reporting requirements, foreign issuers

will take steps to preclude U.S.
which would jeopardize U.S. investors.
ownership. Investors were willing to make initial investments based upon available information; while the 1933 Act assumes U.S. investors cannot fend for themselves and waive compliance with the Act, such a notion imposed upon foreign issuers whose stock is traded without their consent into the U.S. would be offensive to them and a violation of their notions of comity.

- Finally, the briefing materials ask "If sales could be made without restriction to U.S. residents abroad, would primary offerings be likely to be driven offshore?" No, with respect to U.S. issuers, U.S. issuers are sufficiently inured to the Act that they will finance

in the best market. The presence or absence of registration is not a factor. Foreign issuers, however, would probably prefer a Euromarket, especially a Euro-equity market if U.S. institutions could participate. The answer, if that is the case, might be to ease restrictions solely with respect to U.S. institutional investors who have affiliates abroad. Because of the cost of execution, U.S. institutions are in any event the primary purchasers.

I would be glad to answer any questions.

February 17, 1987

SEC Roundtable on Internationalization
of Securities Markets

STATEMENT OF PETER C. CLAPMAN
Senior Vice President & Associate General Counsel
Teachers Insurance & Annuity Association--
College Retirement Equities Fund

I appreciate this opportunity to discuss some of the concerns of CREF about how uncertainty and erroneous misperceptions about U. S. securities laws and the SEC can adversely affect American institutions investing abroad. International investing has proved to be very successful. The record is good even with the investment process being more difficult in some ways. Some problems are inevitable, different time zones, different economic environments. Some problems, however, costing Americans millions of dollars are not inevitable but result from uncertainty and misunderstanding abroad about our laws and regulations. These needlessly prejudice American investors.

Such concerns should be addressed here at this roundtable. I believe we can offer reasonable suggestions as to how the SEC can clarify its position without compromising its regulatory responsibility. The purpose of securities regulation is investor protection. In the overseas market,

currently, misunderstanding is causing not protection of Americans, but prejudice to Americans.

I will discuss these issues from the experience of CREF, a major American institutional investor that has been investing on a global basis since 1973. CREF, along with its companion organization TIAA, provides retirement benefits for the employees--over 800,000 individuals--of over 3,800 colleges and other educational organizations. CREF is all in equities with assets of approximately $28B, $3B being overseas.

How did CREF get a head start in international investing. In 1973, CREF was investing in ADR's of Japanese companies. Those Japanese companies typically issued rights to shareholders--rights that gave the owner the right to buy new shares of the company at an attractive price. ADR holders, however, did not participate in rights offerings--such rights were sold for cash. If the market in such rights were efficient, their cash price should just about match their exercise value.

After a while, we realized that time after time the price we received on the ADR was not the true value of the rights. All other investors exercised the rights and we found they knew what they were doing. This was an inefficient market--and we decided that CREF would not realize the fullest

benefits unless we directly invested in the stock of these foreign companies and could exercise these rights. CREF began direct investing in 1973 in Japan, and expanded to a global investment program in 1978, aiming for about a 10% asset diversification. We have achieved this goal.

CREF has been an active and involved investor in the overseas markets, refusing to take a "no" answer as to last word. For example, when we first started investing, Sweden allowed a very small limit in the amount a foreigner could invest in Sweden. We petitioned the Ministry of Finance and, based on our record of investing for the long term, persuaded that government to give us a much higher limit, enough so that we were able to have an appropriate investment program in Sweden. Likewise in Belgium there is a high withholding tax on dividends. CREF was able to petition the government to issue a Royal Decree exempting educational organizations such as CREF from the tax.

Now, after investing directly for 14 years, we continue to observe that the market inefficiency in the pricing of rights and related offerings we saw in 1973 persists today. This is true not only in Japan, but in all markets. Thus, if an investor cannot exercise rights or otherwise does not have the normal investment prerogatives that all other investors in the country have--we are adversely affected.

Now, where is SEC clarification needed? We have a significant portfolio of British companies. In recent years, in some cases we were precluded from exercising rights offered all shareholders except Americans, based on the erroneous impression that under U. S. law Americans must be excluded. We lost the bargain the rights would have given us--the cash was inadequate for a number of reasons, including high transaction costs and stamp tax. How ironic! We began direct investing abroad to gain the ability to exercise rights. Now, more than 10 years later, we were running into new problems on the same issue.

Why were we excluded? The rights when exercised gave the shareholder newly issued shares. In the U. S., of course, publicly issued new shares must be registered. Some law firms took the position that Americans, therefore, had to be excluded unless the issuers registered in the United States, which they were not prepared to do. It was cheaper and easier simply to exclude Americans. These new shares were identical in all respects to the shares in the British corporation we already owned and accepted the investment risk on.

It can get worse. In some situations the rights to existing shareholders were issued as preemptive rights. Unless the shareholder exercised the rights, such rights simply lapsed. We could not even get cash for the rights we lost.

Now this erroneous perception is even being extended to stock dividends. Companies that for years gave us the opportunity to acquire stock free of high commission costs and stamp duty, deny that opportunity to Americans.

So this is the Catch-22 predicament. Americans can buy stock of a British company in the London markets. They can later buy stock of the same company issued in connection with a rights offering or stock dividends, but only in the aftermarket. In other words, we can buy but not at the bargain price. We think this result is not mandated by the U. S. securities laws. We would like to the SEC to say so.

Let us look at what can happen in a tender offer situation. CREF may own the stock of both Company A and Company B. A makes a tender offer for B's shares which gives all investors the choice of Company A stock or cash. In one case the view was that CREF (and other Americans) could only accept the cash. It is hard to rationalize this result, recalling that CREF already owned A's shares; again a distinction is drawn between A's newly issued shares and its aftermarket shares, a distinction which makes no sense in the marketplace.

In trying to resolve these problems, one situation at a time, I have spoken to many lawyers and investment bankers. We proposed that transactions with CREF were entirely

appropriate as a private placement to an American qualified institutional investor. In some cases, particularly on continental Europe, this view was accepted. It worked in England as well some of the time--we would provide a letter representing to these issuers that we were acquiring the shares for investment purposes--we would keep the securities in custody in the country where the securities were issued, which we always do anyway--and we would sell in an ordinary brokerage transaction in that country. Certainly, however, SEC clarification would have helped, particularly since we did not always have sufficient time to work out the necessary details. For what should be a simple transaction, CREF had to stir up the whole City of London.

We believe this same long-standing recognized American practice of private placements should extend to allow American institutional investors to acquire foreign shares in any new issue as long as the investor does not engage in any resale efforts in the United States. There is, of course, no rational reason for the American investor to sell otherwise than in the foreign markets. Furthermore, if an American investor does not conduct itself properly in this regard, the U. S. securities laws are entirely adequate to sanction and penalize such an American investor who is well within the reach of the SEC. However, we assert that the U. S. securities laws should not be used to preclude Americans from attractive investment opportunities--which this uncertainty more often now causes.

There is a further irony, given the mechanics of how an investor exercises rights or otherwise makes certain types of investments. The managing underwriters receive instructions from custodial banks. The custodial bank must check a box on a form that states that the shares are not held for an American. Obviously, CREF's custodial bank cannot check this box. Yet, an English investment advisory organization that holds shares for the beneficial interest of an American would be allowed to take down these new shares because, as far as the custodial bank is concerned, their records show that a non-American is applying. Thus, this misperception of U. S. law would encourage Americans to have their money managed by non-Americans.

The focus of the new issue problem now turns to France and the new privitization issues. These are issues of stock of companies presently owned by the French government being sold mostly to the French public, with a small amount of stock available to non-French citizens. Such stock has been and is likely to be attractively priced. It is difficult to obtain such stock. An American must take initiative to find out about it--who the underwriters are. Because CREF has been in the French market since 1978, we should normally be able to acquire some shares. A limited amount is available to foreigners--but until now--not to Americans. Why? The French government and French issuers were concerned about doing a private placement with American institutions because of perceived fear of the SEC. Americans were, of course, free to

buy in the aftermarket--after the benefits of the bargain were enjoyed by all others. Hopefully, the SEC will address this issue shortly. Until then, Americans will continue to have difficulty.

A few common themes from these examples can be seen.

First, international investing in securities traded on foreign exchanges is an institutional, not individual investor, market. The SEC should take this reality into account and deal with the issues as they relate to institutional investors, e.g., recognize the long-standing practice in America of private placements, and extend those principles to international investments.

Second, the ability of Americans to participate in rights and other new share offerings is critical. If Americans are precluded, they unnecessarily lose the bargain available by other investors. The amounts of our losses are not trivial. We believe they can be quantified at over $10 million, and there may be an even larger amount of opportunity losses.

Next, the clarification of the ability of American institutional investors to acquire new issues in general with the right safeguards would not compromise the SEC's regulatory concerns. If there are newly issued shares of a major British

company, for example, American investors almost surely will invest in the aftermarket--after the market has given the initial premium to all investors other than Americans. Thus, the shares themselves are not kept out of the hands of Americans, only the shares when they are most attractively priced. The SEC can address this problem by removing the artificial distinction between investing in newly issued shares and the aftermarket--a distinction that here makes no sense.

Looking at the regulatory concern--we believe that the clarification of these issues relating to institutional investors would not risk the victimization of smaller investors in the United States. American institutions engaging in such investment activities normally would keep custody of their securities in the logical country where the shares were issued. Americans normally would--and if necessary, could be required to engage in any sales only outside of the U. S. Again, the purpose of the law is to protect. Uncertainty is causing the law to prejudice.

Finally, why is the role of the SEC so critical. Over the years, while dealing with many foreign institutions sincerely trying to sort out this problem, I must recognize they may be in an understandable dilemma. They may trust the bona fides of what I am saying, probably they instinctively agree with it. However, such foreigners are faced with the

fact that some lawyers are very cautious and that creates a doubt. Many Americans have difficulty understanding the U. S. securities laws. Therefore, a foreigner, in trying to assess jeopardy under these laws, may simply choose to prejudice Americans rather than run any risk at all. This is where the role of the SEC can be critical. The best solution would be for the SEC to remove the unnecessary impediments for an American institution that chooses to invest abroad. We necessarily take on the risks of such investment--but we should also have the full range of opportunities such investments may bring. Certainly, Americans should have no less opportunity than investors of other countries.

In conclusion, I would again commend the SEC for beginning the process to better develop the appropriate standards for how and when the U. S. securities laws should intervene when American institutions invest abroad.

CHAPTER VI

Investment Companies and Advisers and the Internationalization of the Securities Markets

Prepared by the Division of Investment Management

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CHAPTER VI

INVESTMENT COMPANIES AND ADVISERS AND THE INTERNATIONALIZATION OF THE SECURITIES MARKETS

A. Introduction

Investment companies and investment advisers have participated actively in the internationalization process. Since 1983, the number of domestic open-end investment companies that concentrate their portfolio investments in foreign securities has nearly tripled and the total assets of these companies have grown from $3.5 billion to over $14 billion as of the end of the fiscal year. The activities of foreign investment advisers in the U.S. also have increased: 127 foreign investment advisers from 20 countries have registered as investment advisers with the Commission.

Foreign participation in the U.S. investment company market, however, has been slow. The Investment Company Act of 1940 ("ICA") requires that foreign investment companies obtain an order of the Commission permitting them to register under the ICA and to make a public offering of their shares. The Commission may not issue the order unless it finds that special circumstances or arrangements make it legally and practically feasible to enforce the provisions of the ICA effectively against the company and that the order is consistent with the public interest and the protection of investors. Because of these strict statutory conditions, only nineteen orders allowing registration have been issued by the Commission since the adoption of the ICA. Consequently, the principal means by which foreign sponsors can bring an investment company product to the

U.S. market is by organizing a "mirror" fund in the U.S., under U.S. law.

U.S. investment companies also have experienced difficulties in marketing their shares abroad, for different reasons in different countries. The lack of uniformity among regulatory schemes makes it difficult for any single investment company, whether U.S. or foreign, to be marketed on an international basis.

The Commission staff is studying means to permit cross-border marketing of investment company shares, primarily through reciprocal agreements with foreign regulators. To explore this, the staff has developed contacts with foreign regulators and with international organizations of securities regulators. The staff initiative in this area is based on the premise that if the regulatory scheme of a foreign nation serves the same purposes as the ICA, it may be possible to rely upon foreign law for certain types of investor protection, rather than requiring that a foreign investment company comply with all the provisions of the ICA before offering shares in the U.S. Implementing this approach, however, might require Congressional action.

This chapter discusses the extent to which investment companies and investment advisers are participating in the internationalization process and summarizes the barriers that presently inhibit international activity. The chapter also describes steps taken by the Commission and staff to date to address these barriers.

B. Participation by Foreign and Domestic Investment Companies and Investment Advisers in the Internationalization of the Securities and Currency Markets

1. Participation In Foreign Markets by Domestic Institutional Investors

Increasingly, individual investors in the United States are using management investment companies of the open-end ("mutual funds") and closed-end types as a means of participating in the securities markets. 1/ By investing in these funds, investors of modest means can attain a level of diversification and professional management that otherwise would be unavailable to them. As the securities markets have become more global in scope, funds have been organized with investment policies that require or allow a significant portion of fund assets to be invested in securities of foreign issuers. These funds allow U.S. investors to invest in foreign securities without the costs and administrative burdens of conducting transactions directly in foreign markets.

The growth in the number and assets of funds that invest abroad is demonstrated by data compiled by the Investment Company Institute ("ICI"), a trade association for the U.S. mutual fund industry. In 1983, there were 21 mutual funds that had investment objectives specifically requiring the investment of all or part of fund assets outside the United States. These 21 funds had total

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1/ While U.S. investors also are investing in unit investment trusts ("UITs"), participation by UITs in the internationalization process has been limited. UITs are open-end investment companies that invest in a fixed, rather than a managed, portfolio of securities.

assets of approximately $3.5 billion. By December 1985, there were 42 such funds with assets of approximately $8 billion. As of September 1986, the number of mutual funds investing abroad had grown to 53, with assets of approximately $14.7 billion. The ICI figures on investment abroad do not include closed-end funds, mutual funds that concentrate their investments in the securities of companies that mine precious metals, or unit investment trusts. Commission records indicate that, as of October 29, 1986, 114 investment companies of all types that invest or intend to invest abroad had registered or were in the process of registering under the ICA. Of these, the 97 funds that were operating and for which information was available had total assets of approximately $23.5 billion, with an average 78.4% of each fund's assets invested in foreign securities.

In addition to investment companies, other pooled investment vehicles, such as employee benefit plans, are investing increasingly outside the United States. According to surveys of the fifty largest international investment advisers conducted by Pensions and Investment Age, a trade publication, as of March 31, 1987, U.S. tax-exempt assets invested abroad totalled approximately $37.0 billion. This amount was invested primarily in equity ($32.6 billion) and fixed income ($4.7 billion) securities. The total figure for such investment abroad represented an increase of 13.5% over the $32.6 billion total invested abroad by tax-exempt entities as of March 31, 1986 and 133% over the $15.9 billion

total invested abroad by tax-exempt entities as of March 31, 1985. 2/

2. Participation by Foreign Institutional Investors in the U.S. Securities Markets

In the past few years participation by non-U.S. investment advisers in the United States securities markets also has increased. One measure of this increase is the number of non-resident institutional investment managers required to file Form 13F with the SEC. 3/ A review of Form 13F filings for the calendar quarters between the first quarter of 1981 and the third quarter of 1986 indicates that the number of foreign 13F filers increased dramatically in late 1985 and 1986 after remaining relatively constant between

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2/ See International, Global Assets, Pensions and Investment Age (June 29, 1987) at page 35; Overseas Assets Rose to $32.6 Billion, Pensions and Investment Age (August 4, 1986) at page 15. See also International Equities' Dilemma: How do you top 1985? Pension World, Vol. 22 No. 4 (April, 1986) at page 26.

3/ Under Section 13(f) of the Securities Exchange Act of 1934 and Rule 13f-1, 17 CFR 240.13f-1, each institutional investment manager that uses the instrumentalities of interstate commerce in its business and that exercises investment discretion over certain equity securities ("13(f) securities") having an aggregate fair market value of $100 million (as of the last trading day of any month of a given calendar year) must file Form 13F with the SEC. The form discloses information such as the identity, number and market value of the 13(f) securities that are subject to the manager's discretion.

1981 and 1985. 4/ This increase reveals that a growing number of foreign institutional investment managers are exercising investment discretion over U.S. equity securities. 5/

4/ This is summarized in the following chart:

Quarter	Total 13F Filers	Foreign 13F Filers
1-81	786	227
2-81	804	239
3-81	727	201
4-81	774	222
1-82	804	210
2-82	791	204
3-82	783	202
4-82	821	209
1-83	829	205
2-83	857	205
3-83	869	199
4-83	884	213
1-84	926	211
2-84	999	219
3-84	896	199
4-84	880	190
1-85	971	228
2-85	996	254
3-85	977	260
4-85	1,020	284
1-86	982	332
2-86	1,025	377
3-86	1,032	399

5/ Data is not available on the total number of foreign managers exercising investment discretion over U.S. equity securities or the total value of the securities subject to their discretion. The total value of 13(f) securities reported by the 399 foreign managers filing Form 13F for the third quarter of 1986 has not been compiled, but would represent discretion over at least $39.9 billion in 13(f) securities by these managers. Foreign institutional investment managers with investment discretion over less than $100 million in 13(f) securities are not required to file Form 13F.

The increasing participation of foreign investment advisers in the U.S. securities markets also is demonstrated by the number of advisers that have registered under the Investment Advisers Act of 1940 ("IAA"). 6/ Commission records indicate that 127 foreign investment advisers from 20 countries have registered under the IAA. This number does not include registered investment advisers domiciled in the U.S. that are affiliated with foreign investment advisers, such as U.S. subsidiaries of foreign advisers. These advisers are considered domestic advisers.

Although foreign advisers have become more active in U.S. securites markets, participation by foreign investment companies has been slow. Foreign investment companies cannot publicly offer their shares in the U.S. without registering under the ICA and only five active foreign investment companies, four Canadian and one

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6/ Sections 202(a)(11) and 203(a) of the IAA generally require a foreign investment adviser to register if the adviser (1) engages, for compensation, in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; and (2) uses the mails or any instrumentality of interstate commerce in connection with such advisory business. As defined in Section 202(a)(10) of the IAA, the term "interstate commerce" includes "trade, commerce, transportation, or communication . . . between any foreign country and any State . . . ." The SEC staff, on a number of occasions, has indicated that nonresident foreign investment adviser that have no U.S. clients but simply use the instrumentalities of interstate commerce in connection with their foreign advisory business need not register under the IAA. See, e.g. Double D. Management, Ltd. (pub. avail. Jan. 31, 1983). For a more detailed review of SEC and staff positions relating to the applicability of the IAA to foreign investment advisers, see Judd, International Investment Advisers, 19 Securities and Commodities Regulation 1 (Jan. 8, 1986).

South African, are presently registered. The small number of registered foreign investment companies is attributable to Section 7(d) of the ICA which, as discussed in the next section, inhibits foreign investment companies from registering under the ICA. However, the Commission staff takes the position that Section 7(d) does not prevent an unregistered foreign investment company from making a private offering of its securities in the U.S., so long as it has and will have no more than 100 U.S. shareholders. 7/ This position is based on an analogy to Section 3(c)(1) of the ICA, which exempts from the definition of an "investment company" any issuer whose outstanding voting securities are beneficially owned by fewer than 100 persons and that is not making and does not propose to make a public offering of its securities. Because foreign companies relying on this position are not required to register under the ICA, the staff cannot determine the number of foreign investment companies privately offering their shares in the U.S. 8/

7/ See Touche Remnant & Co. (pub. avail. Aug. 27, 1984).

8/ A foreign investment company making a private placement of its securities in the U.S. could rely on the "safe harbor" from the registration of those securities provided by Regulation D under the Securities Act of 1933. However, a company relying on Regulation D would have to file Form D with the Commission. A recent review of Form D filings did not indicate any filings by foreign investment companies.

C. Regulatory Limitations on the Participation of Investment Companies in International Securities Markets

1. Barriers Confronting Foreign Investment Companies Seeking to Issue Shares in the U.S.

Section 7(d) of the ICA prohibits an investment company that is not organized under the laws of the United States or of a State of the United States from publicly offering securities in this country unless it obtains an order from the Commission under Section 7(d). That section authorizes the Commission to allow a foreign investment company to register under the ICA if the Commission finds that (1) by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce effectively the provisions of the ICA against the applicant; and (2) the issuance of an order is otherwise consistent with the public interest and the protection of investors.

In the early 1950's, several investment companies organized in Canada sought permission under Section 7(d) to register under the ICA and offer their securities in the United States. Based on its review of these applications, in 1954 the Commission adopted Rule 7d-1 under the ICA which sets forth the minimum conditions and undertakings necessary for a Canadian investment company to obtain an order under Section 7(d). 9/ The rule requires, among other things, that: (1) fund assets and records be kept in the

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9/ Rule 7d-1 [17 CFR 270.7d-1] was proposed in Investment Company Act Release No. 1945 (Jan. 28, 1954) and adopted in Investment Company Act Release No. 1973 (Apr. 27, 1954).

U.S., (2) the fund charter and by-laws contain in substance, certain specified provisions of the ICA and be enforceable in the U.S., and (3) a majority of the fund's officers and directors be U.S. citizens, with a majority of the U.S. citizens resident in the U.S.

From 1954 to 1973, the Commission issued exemptive orders under Section 7(d) to nineteen foreign investment companies. Thirteen of these funds were Canadian and the other six were organized under the laws of countries with common law traditions. 10/ All of the funds that received orders complied with the substantive provisions of Rule 7d-1.

To explore standards for permitting registration of foreign investment companies under the ICA, the Commission requested public comment on these issues in 1974. 11/ The Commission asked for comment on whether the Standard Rules formulated by the Organization for Economic Cooperation and Development ("OECD") to provide minimum requirements for mutual funds could be the basis for permitting foreign funds to issue their shares in the U.S. The Standard Rules, which are discussed below, were developed in 1972 after extensive deliberation by OECD member nations including the U.S.

10/ The other orders were issued to two funds organized in Australia, two in Bermuda, one in South Africa and one in the United Kingdom. Of the nineteen funds that received orders, only five are presently active. Four of these are Canadian and one is South African.

11/ *See* Investment Company Act Release No. 8596 (Dec. 2, 1974).

Many of the commentators that discussed the OECD Standard Rules expressed the opinion that decisions on whether foreign investment companies should be allowed to sell their shares in the United States should be made on a case-by-case basis, and should not be based solely on compliance with the minimum requirements embodied in the Standard Rules because the provisions of the Standard Rules are, in many respects, less stringent than those of the ICA. These commentators believed that foreign investment companies allowed to issue their shares in the U.S. while complying only with foreign regulations might have a competitive advantage over U.S. funds complying with the ICA. Additionally, one commentator suggested that if foreign investment companies were not required to comply with certain requirements of the ICA, domestic corporations might reorganize under foreign law to circumvent those ICA requirements. After considering the comments the Commission concluded that, in light of the specific requirements of Section 7(d), it should continue to determine whether foreign investment companies could register under the Act on a case-by-case basis. To provide guidance to potential applicants the Commission issued a release discussing the minimum prerequisites for a foreign investment company to obtain an order under Section 7(d). 12/

12/ *See* Investment Company Act Release No. 8959 (Sept. 26, 1975).

In 1977, the Commission began to review a draft application, submitted formally in 1980, for registration under the ICA of a fund organized in a civil law country. The application of Union-Investment-Gesellschaft m.b.h. (Union-Investment"), an investment management firm in the Federal Republic of Germany ("FRG"), for a Commission order under Section 7(d) to allow Unifonds, a mutual fund in the FRG, to register under the ICA, presented many novel and difficult issues because of significant differences between investment company regulation in the FRG and the U.S. In spite of extensive efforts, the Commission was unable to resolve the issues raised by the Unifonds application in a manner that satisfied the requirements of Section 7(d) and, in 1983, Union-Investment withdrew the application.

As a result of the problems presented by the Unifonds application, the Commission issued another release in 1983 suggesting that foreign investment companies could avoid the problems presente by Section 7(d) by registering a "mirror fund." A mirror fund is an investment company organized under the laws of the United States to invest primarily in the same securities in which an existing foreign investment company invests. 13/

Additionally, in January, 1984, the Commission transmitted to Congress a recommendation to amend Section 7(d) of the ICA to allow the Commission to permit foreign investment companies to

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13/ See Investment Company Act Release No. 13691 (Dec. 23, 1983).

register under the ICA and publicly offer their shares in the U.S. under certain circumstances. Specifically, the Commission sought authority to exempt certain operating foreign investment companies from provisions of the ICA if the Commission finds that, given the nature of the foreign company, compliance with those provisions would be unduly burdensome and either that the foreign law under which the company operates provides protections for investors that serve the same purposes as the protections provided by those provisions of the ICA from which exemptions are sought, or that such investor protection is provided by specific conditions agreed to by the company. Also, the Commission would be required to find that the exemption is consistent with the protection of investors and the purposes intended by the policy of the ICA and that the foreign company is not operated for the purpose of evading the provisions of the ICA. In the memorandum accompanying the proposal, the Commission stated that it based its recommendations on the notion that, given the growing internationalization of the securities markets, the present requirements of Section 7(d) operate to unreasonably impede the natural development of international markets and competition. To date, the proposal has not been introduced in either House of Congress.

2. Barriers Confronting U.S. Investment Companies Seeking to Issue Shares Abroad

Although it has become more common for investment companies registered under the ICA to issue their shares in foreign countries,

a number of factors still discourage U.S. funds from marketing their shares abroad. These include the burden of complying with foreign regulations in addition to U.S. regulations, 14/ and the relatively small number of potential shareholders in many foreign countries. However, as foreign governments relax regulatory barriers to the sale of U.S. fund shares within their boundaries and the foreign markets for such shares grow, it is likely that additional U.S. companies will seek to market their shares outside the United States. 15/

Historically, many foreign countries have imposed restrictions to prevent or limit the flow of capital across their borders to other countries. An example is the foreign exchange controls that govern transactions by Italian citizens in foreign securities. Until recently, Italians investing abroad were required to deposit fifty percent of the value of any foreign securities purchased into

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14/ The Commission has taken the position that an open-end investment company registered under the ICA that sells its shares outside the United States is required to comply with substantially the same disclosure requirements with respect to foreign investors as would be required for domestic investors. See Investment Company Act Release No. 6082 (June 23, 1970).

15/ A more detailed country-by-country analysis of foreign mutual fund regulation, together with a broader discussion of the regulatory treatment of U.S. banking and securities firms by specific foreign countries, is contained in the 1986 Update to the September 1979 "National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations" ("1986 Update"), which was submitted to the Senate Committee on Banking, Housing and Urban Affairs by the Department of the Treasury in December 1986.

a non-interest bearing account. 16/ Another example is provided by the French laws requiring French residents to hold any foreign securities purchased abroad within France and to repatriate the proceeds of overseas securities trading to France within three months. Moreover, until May 1986, French residents seeking to purchase foreign securities were required to obtain the foreign currency necessary to do so at a premium on a foreign exchange market specifically designated for buyers and sellers of foreign securities. 17/

In addition to regulations designed to discourage residents from investing abroad, many foreign countries have imposed licensing and other requirements on foreign investment companies that, in some cases, are stricter than those placed on domestic funds. Even where compliance with a particular country's regulations is not burdensome, many U.S. investment companies prefer to sell shares solely in the U.S. This preference may result because in order to have access to a large enough market of potential investors, a fund may have to offer its shares in several foreign countries. Because the regulatory schemes of foreign nations generally have not been compatible with each other or with the ICA, compliance with several regulatory schemes becomes onerous, even though complying with the requirements of any one nation might not be burdensome.

16/ This deposit requirement recently has been reduced to fifteen percent of the value of the securities purchased. See 1986 Update at 210.

17/ See 1986 Update at 199.

Nevertheless, a number of developments have occurred that could make foreign markets more accessible and attractive to U.S. investment companies. First, as noted above and discussed in more detail in the 1986 Update, many foreign nations are relaxing regulation of investment companies organized in other countries. Second, the market for investment company shares in many foreign countries is expanding as the securities markets in those countries mature and collective investment vehicles such as mutual funds become more attractive to individual investors. For instance, since the organization of mutual funds in Italy was authorized in 1983, there has been a rapid growth in the number and size of such funds. By April 1986, forty-eight mutual funds had been established in Italy 18/ and, by July 1986, approximately one and a half million Italian residents had invested more than $25 billion in mutual funds. Since this amount represents only a small percentage of the $466 billion in total savings held by Italians, the potential market for fund shares in Italy is quite large. 19/ The growing popularity of mutual funds in Italy and other countries is likely to attract U.S. fund sponsors to foreign markets, despite regulatory barriers.

18/ *See* 1986 Update at 209.

19/ *See* Markin, *Fund Mania, Italian Style*, Institutional Investor (International Edition) (July 1986) at 80.

D. Recent Initiatives Relating to Investment Company Participation in the Internationalization Process

1. The Possibility of Reciprocal Arrangements Between the United States and Foreign Nations or Organizations with Respect to Multinational Offerings of Mutual Fund Securities

The Commission has received inquiries regarding the possibility of bilateral arrangements between the U.S. and foreign governments to allow mutual funds registered in one country to sell their shares in the other country without meeting additional compliance measures. Commission staff have met informally with Japanese and Canadian securities regulators to discuss the possibility of reciprocal arrangements.

Bilateral agreements to achieve reciprocity would require that the United States negotiate a separate agreement with each nation. As an alternative, the Commission staff is exploring the possibility of achieving reciprocity for the sale of fund shares by an agreement with an international organization such as the European Economic Community ("EEC") or the OECD. This approach has been supported by representatives of the U.S. mutual fund industry and by the European Federation of Investment Funds and Companies, which is comprised of mutual fund trade associations from nine European countries. Under this approach, foreign mutual funds would be allowed to issue securities in the U.S. as long as the funds were organized under the laws of a country that had implemented a set of regulatory standards approved by the international organization. Funds complying with the provisions of the ICA would be able to

issue securities in member nations of the international organization that had implemented the regulatory standards. The EEC Council Directive 85/611/EEC "on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)" (the "Directive"), and the "Standard Rules for the Operations of Institutions for Collective Investment in Securities" (the "Standard Rules") proposed by the OECD could serve as the basis for such a reciprocal arrangement However, as discussed below, neither the Directive nor the Standard Rules provide a regulatory framework directly comparable to that of the ICA. Therefore, any negotiations for a reciprocal agreements based on either the Directive or the Standard Rules would have to address the differences between those regulatory guidelines and the ICA.

The EEC Directive was adopted on December 20, 1985 to facilitate marketing within the EEC of certain collective investment products, while ensuring a minimum level of investor protection. The products covered are roughly equivalent to open-end, management, diversified registered investment companies under the ICA. The Directive provides that EEC Member Nations must conform their laws to its terms by October 1989. Although it is not certain that all EEC member nations will comply with this deadline, the Directive represents a significant step toward eliminating regulatory barriers to multinational offering of securities by mutual funds organized in EEC member nations. The Directive could provide a starting point

for negotiations between the United States and the EEC with respect to a treaty allowing reciprocal sales of mutual fund shares.

The Directive is not self-operative, but depends on the enactment by EEC members of implementing legislation and regulations. While it contains provisions relating to the organization, structure, management, authorization, business practices and investment policies of diversified mutual funds, the Directive allows EEC member nations some flexibility to structure the regulation of these funds within their borders. Member states may define a category of fund that would be exempt from all provisions of the Directive upon a finding that the rules in the Directive relating to investment and borrowing policies are inappropriate for that category. The Directive also grants member states broad discretion to modify the provisions relating to diversification of assets and to regulate any area not addressed in the Directive. For these reasons, it is not expected that the Directive will result in EEC members having identical regulatory schemes for diversified mutual funds.

Nevertheless, the Directive should result in certain minimum standards for diversified mutual funds throughout the EEC. These standards include requirements that: (1) directors of the management company be of good repute and have sufficient experience to perform their duties (Article 4); (2) fund assets be maintained in the custody of a depository subject to public control (Articles 7 and 8); and (3) management companies limit their activities to the management of unit trusts and investment companies (Article 6).

Additionally, member nations must enact legislation to ensure that the entities involved with these funds are financially able to conduct business effectively and meet their liabilities, and to otherwise satisfy the goals of the Directive with respect to the protection of shareholders. Finally, the Directive would require each fund to publish a prospectus that includes the minimum information necessary for investors to make an informed judgment as to the investment proposed to them, and annual and semi-annual reports that would include financial statements.

There are a number of significant differences between the regulatory scheme of the Directive and that of the ICA. The Directive contains no provisions, comparable to Sections 17 and 10(f) of the ICA, that explicitly address the question of affiliated transactions 20/ or limit the ability of a fund to acquire portfolio securities during the existence of an underwriting or selling syndicate where an officer, director, advisory board member, investment adviser or employee of the fund, or any affiliated person of such persons, is acting as a principal underwriter for the issuer of the security. Other differences could arise as a result of implementing legislation and regulations enacted by EEC member nations. It would be possible for such legislation to conflict with the type of regulation provided for in the ICA,

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20/ Such transactions may be addressed implicitly by the provisions of the Directive requiring depositories, which handle all asset transactions, to act solely in the interests of shareholders (Article 17).

while still complying with the general regulatory framework provided by the Directive. For instance, under the Directive a member nation could allow fund assets to be maintained in a depository that would not qualify as a custodian of investment company assets under Section 17(f) of the ICA. Also, because the Directive leaves to the member states regulation of retail pricing of fund shares, a member state could allow fund shares to be priced in a manner inconsistent with Section 22 of the ICA and Rule 22c-1 thereunder, which require that the issuance and redemption price of mutual fund shares be based on the fund's net asset value per share next calculated after receipt of a purchase or redemption order.

The Standard Rules formulated by the OECD also might form the basis for a reciprocal arrangement. These rules were developed in 1972 after extensive deliberation by representatives of the member nations of the OECD, including the United States. 21/ The Standard Rules were intended to provide minimum requirements for the investment management and marketing practices of, and the protection of investors in, collective investment institutions, defined as roughly comparable to open-end investment companies under the ICA. The Standard Rules were not intended to supplant

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21/ At that time, the members of the OECD were Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission provided one of the United States representatives.

the ability of OECD members to regulate the sale of securities of foreign funds within their borders but only to provide OECD member nations with a starting point for developing parallel regulations. In this regard, the OECD specifically recognized that members could impose regulatory requirements in addition to those contained in the Standard Rules.

Many provisions of the Standard Rules are either less restrictive than those of the ICA or give member countries the discretion to be less restrictive. For example, the Standard Rules provide that the title to fund assets must be held in a manner acceptable to the appropriate supervisory authority; Section 17(f) of the ICA specifically requires funds to maintain securities and similar investments in the custody of a bank, a member firm of a national securities exchange, or the investment company itself in accordance with Commission rules. 22/ Additionally, because the term "bank," as defined in the ICA, does not include a foreign bank, an investment company requires exemptive relief from the ICA in order to maintain its portfolio securities in the custody of a foreign bank. 23/ The

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22/ Rule 17f-2 under the ICA requires an investment company acting as a self-custodian to deposit its securities and similar investments in the safekeeping of a bank or other company whose functions and physical facilities are supervised by federal or state authorities.

23/ Rule 17f-5 provides exemptive relief for management investment companies to maintain their assets outside the U.S. in the custody of an "eligible foreign custodian," which includes a foreign bank that has shareholders' equity in excess of $200 million.

Standard Rules give OECD members similar flexibility in other areas that are subject to specific statutory and regulatory restrictions under the ICA. These include: (1) valuation of investment company assets; (2) the frequency for valuing and pricing fund shares; and (3) the time period in which to honor redemption requests.

Following the promulgation of the Standard Rules, the OECD recommended, with the support of the Commission, that each member nation (1) review its existing legislation and regulations in light of the Standard Rules; (2) consider the Standard Rules when preparing new legislation or regulations; and (3) give substantial weight, within the framework of its legislation, to the fact that a foreign fund applying for permission to offer securities within that member nation has complied with the Standard Rules. As discussed above, the Commission sought comment in 1974 on whether compliance with the Standard Rules could be the basis, under Section 7(d) of the ICA, to permit a foreign fund to operate in the U.S. Although the Commission determined in 1975 to continue to consider Section 7(d) applications on a case by case basis, it may be appropriate to reexamine the Standard Rules as a possible basis for negotiation of a reciprocal arrangement, and amendment to section 7(d), to facilitate cross-border marketing of mutual funds.

Whether it would be possible to negotiate a reciprocal arrangement to allow U.S. investment companies to issue their securities abroad and foreign investment companies to issue their securities

in the United States will depend upon a number of factors. Under the EEC Directive and the OECD Standard Rules, members could enact regulatory requirements in certain areas that are less stringent than those of the ICA. Allowing foreign funds to issue shares in the United States while complying only with foreign standards may not provide U.S. investors in a foreign investment company with the level of protection available to investors in an investment company that is complying with the requirements of the ICA. Such an action could also place U.S. investment companies at a competitive disadvantage to foreign funds. Accordingly, any reciprocal treaty should seek to ensure that (1) U.S. investors in foreign investment companies selling shares in the United States receive protection that is comparable to that received by investors in investment companies organized in the U.S. and operated in accordance with the ICA, and (2) U.S. investment companies are not placed at a competitive disadvantage to foreign investment companies, whether in the United States or abroad.

2. Easing Restrictions on the Ability of Foreign Banks to Issue Securities in the U.S.

Recently, the Commission has taken steps to facilitate U.S. offerings of securities by foreign banks. Under the ICA foreign banks may be precluded from offering their securities in the U.S. in the absence of a Commission exemption. A foreign bank is considered an investment company under the ICA to the extent that it is involved in owning, holding, trading, investing or reinvesting

in securities. 24/ Although Section 3(c)(3) of the ICA specifically excepts U.S. banks from the definition of investment company, that exception does not extend to foreign banks. Therefore, before offering securities in the U.S., a foreign bank or its finance subsidiary must either register as an investment company or apply to the SEC for an exemptive order.

During the past six years, the SEC has granted an average of 20 exemptive orders annually to foreign banks and their finance subsidiaries to permit them to offer or sell their debt securities in the United States without registering under the ICA. On September 10, 1986, the Commission proposed Rule 6c-9 under the ICA to remove the requirement that foreign banks obtain individual exemptive orders. The proposed rule generally would permit a foreign bank or its finance subsidiary to offer or sell its own debt securities or non-voting preferred stock in the U.S. without registering as an investment company if (1) the securities are registered under the Securities Act of 1933, or (2) where the issuer can rely on an exemption from such registration, the securities are assigned one of the two highest ratings available from at least two nationally recognized statistical rating organizations. Proposed Rule 6c-9 also would require that (1) any securities offered or sold by a finance subsidiary of a foreign bank be unconditionally guaranteed by its parent; (2) any convertible or exchangeable securities be

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24/ See Investment Company Act Release No. 15314 (Sept. 17, 1986).

convertible or exchangeable only for securities issued by a finance subsidiary's parent or for other debt or non-voting preferred stock of the subsidiary; (3) a finance subsidiary remit at least 85% of the offering proceeds to its parent no later than six months after receipt; (4) a subsidiary not invest the offering proceeds in securities other than government securities, 25/ commercial paper or securities issued by its parent or a company under common control; and (5) any foreign bank or non-U.S. subsidiary of a foreign bank relying upon the rule file a form with the Commission appointing an agent in the U.S. for service of process.

In 1986, the Commission for the first time permitted foreign banks to issue equity securities in the United States without registration under the ICA. Westpac Banking Corporation, an Australian bank, and Barclays PLC and National Westminster Bank PLC, British bank holding companies, were granted orders of exemption under Section 6(c) of the ICA, 26/ subject to several conditions.

25/ The term "government security" is defined in Section 2(a)(16) of the ICA as any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by Congress, or any certificate of deposit for any such securities.

26/ Section 6(c) of the ICA gives the Commission authority, by rules and regulations upon its own motion or by order upon application, to conditionally or unconditionally exempt any person, security or transaction or any class of persons, securities or transactions from any provisions of the ICA or regulations under the ICA upon a finding that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the ICA.

The conditions included that the foreign banks have a substantial presence in the United States and be regulated as banks both in their home country and in the United States. 27/

27/ See notices of application and orders for Westpac Banking Corporation, Investment Company Act Release Nos. 15181 (June 27, 1987) and 15217 (July 23, 1986); Barclays PLC, Investment Company Act Release Nos. 15189 (July 2, 1986) and 15228 (July 29, 1986); and National Westminster Bank PLC, Investment Company Act Release Nos. 15211 (July 18, 1986) and 15248 (August 12, 1986).

CHAPTER VII

ENFORCEMENT OF THE U.S. SECURITIES LAWS IN A GLOBAL SECURITIES MARKET

The accelerating internationalization of the securities markets has presented new opportunities for investors and securities professionals to utilize capital legitimately in innovative ways. But the ability to effect transactions in and between the markets of many nations also has afforded the unscrupulous new opportunities exploit others and to violate the federal securities laws. In particular, those who seek to engage in illegal trading while in possession of nonpublic information have attempted to conceal their activities by conducting their trading through foreign entities.

This trend toward the internationalization of fraud is illustrated in SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y., June 3, 1986), appeal pending, No. 86-6192(L) (2d Cir.). In that case, the court found that Tome, an Italian securities professional with substantial business in the U.S., had exploited a confidential relationship with Edgar Bronfman, the chairman and chief executive officer of Seagrams, to obtain and misuse material, nonpublic information concerning Seagram's planned takeover bid for St. Joe Minerals Corporation. Tome and his tippees bought large quantities of St. Joe call options and common stock the day before the announced takeover bid.

Tome, an Italian national currently residing in Switzerland, purchased the St. Joe securities through brokerage accounts maintained at a Swiss bank, Banca Della Svizzera Italiana ("BSI")

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Prepared by the Division of Enforcement and the Office of the General Counsel

in the names of three Panamanian entities in which he had a beneficial interest. Tome also tipped certain individuals and entities in Europe. 1/

The court found that Tome violated Section 10(b) of the Securities Exchange Act and Rule 10b-5, by misappropriating valuable corporate information, entrusted to him by Bronfman for the purpose of advising Bronfman and Seagrams, for his own benefit. The three Panamanian entities were found to be equally liable for Tome's violations. Although the identified tippee purchasers, Leati and Lombardfin, did not appear at trial, the court ruled that the Commission had effected personal service on all defendants pursuant to Rule 4 of the Federal Rules of Civil Procedure by publication in newspapers of general circulation in Europe. Both Leati and Lombardfin were found liable for violations of Section 10(b) and Rule 10b-5.

Significantly, the court also ordered the New York branch of BSI to request that the frozen proceeds from the illegal trading in St. Joe securities be transferred to it from BSI in Lugano, Switzerland for subsequent deposit with the

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1/ Initially, the Commission was unable to determine the identity of the tippee purchasers. The Commission was subsequently able to identify as purchasers of St. Joe call options Paolo Leati, a resident of Italy and a friend of Tome, and Lombardfin S.p.A., a foreign holding company formed by Leati for subsidiaries and affiliates engaged in securities brokerage. At trial, on October 23, 1985, the court granted the Commission's motion to amend the complaint to include both Leati and Lombardfin.

court. BSI agreed to pay the required sums. After the commencement of the SEC investigation, Tome fled the United States, and has not returned.

The increasing frequency with which foreign corporations are incorporating entities in the United States, which thereafter register and sell securities, also has presented problems in enforcing the securities laws. In such cases the operations of the parent may be wholly located abroad and the capital raised as a result of the offering immediately exported for use in the parent's operation. Accordingly, if there are irregularities in the initial disclosure made in the company's registration statement, or if the company has engaged in fraud, the money may have left the United States before any action can be taken. Where this occurs, problems associated with gathering evidence to prove the fraud, as well as recovering the money from a foreign jurisdiction, arise. Thus, the Commission's best, and most practical, opportunity to protect investors may occur prior to the time the registration statement goes effective.

In SEC v. Balsa Donde USA and Arye Donde a/k/a Arik Donde, Civil Action No. 86-3373 (U.S.D.C., December 9, 1986), the Commission sued Balsa Donde USA, Inc. ("Balsa Donde") and Arye Donde ("Donde") seeking Final Judgments of Permanent Injunction from violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act. Balsa Donde was a Delaware corporation with manufacturing facilities located in Israel, which manufactured airframe components for remote piloted vehicles ("RPV's"). Donde was chief

operating officer, and a vice president and director of Balsa Donde. The Commission's complaint alleged that Balsa Donde filed with the Commission a registration statement on Form S-1 on May 23, 1986, and an amended registration statement on September 5, 1986, which contained false and misleading statements of material facts. The defendants consented to the court's entry of a judgment of final injunction without admitting or denying the Commission's allegations.

In a related action, the Commission issued an Order Instituting Proceedings Pursuant to Section 8(d) of the Securities Act, and Findings and Stop Order suspending the effectiveness of the registration statement filed by Balsa Donde and ordered Balsa Donde to return investors' money. In the Order, the Commission found that Balsa Donde's registration statement contained untrue statements of material facts and omitted to state material facts required to be stated or necessary to make the statements not misleading. Balsa Donde consented to the issuance of the Order without admitting or denying the Commission's findings.

The Commission has been vigorous in enforcing the U.S. securities laws to protect U.S. investors and the integrity of U.S. markets. In this effort, the ability of the Commission's staff to obtain evidence located overseas has been crucial. This Chapter examines the means that the Commission has employed to obtain this evidence including multilateral and bilateral agreements. First, however, the Chapter examines the extent of U.S. jurisdiction under the federal securities laws and the tests

employed by U.S. courts in determining whether that jurisdiction exists and may appropriately be exercised.

I. APPLICATION OF U.S. JURISDICTION IN SECURITIES CASES

A. Introduction

The federal securities statutes contain broad statements of jurisdiction, premised generally on securities transactions and related activities conducted through interstate or foreign commerce involving any point in the United States, or through the mails. 2/ Thus, in addition to covering wholly domestic transactions, the federal securities laws have been construed to cover transactions initiated in the United States and consummated abroad, as well as those initiated abroad and concluded in the

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2/ Section 2(7) of the Securities Act, 15 U.S.C. 77b(7), defines "interstate commerce" to include "trade or commerce in securities or any transportation or communication relating thereto * * * between any foreign country and any State, Territory, or the District of Columbia * * *." The Securities Exchange Act 3(a)(17), 15 U.S.C. 78c(a)(17), contains a similar definition. See also Section 2(a)(18) of the Investment Company Act, 15 U.S.C. 80a-2(a)(18), and Section 202(a)(10) of the Investment Advisers Act, 15 U.S.C. 80b-2(a)(10). The preambles to both the Securities Act and the Securities Exchange Act state that they are intended to apply to "interstate and foreign commerce."

Two provisions of the federal securities statutes expressly refer to foreign participation in the securities markets. Securities Exchange Act Section 30 prohibits the use of foreign stock exchanges in contravention of Commission rules for the protection of investors and to prevent evasion of the Act (15 U.S.C. 78dd), and Section 7(d) of the Investment Company Act authorizes the Commission to issue an order permitting a foreign investment company to be registered in the United States and to make a public offering of its securities if the Commission finds that such an order is consistent with the public interest and the protection of investors, and that it can effectively enforce the provisions of that Act against such company. 15 U.S.C. 80a-7(d).

United States. 3/

In general, the courts will exercise subject matter jurisdiction under the securities laws based on the existence of significant conduct or effect in the United States. Courts have tended to be more receptive to the exercise of United States jurisdiction in fraud cases than in those involving regulatory matters. Jurisdiction under the federal securities laws is also limited by the willingness of other states to tolerate or respect the exercise of United States jurisdiction in the particular circumstances. These restrictions are the subject of two recent scholarly projects of the American Law Institute. 4/

B. Jurisdiction of the Federal Securities Laws: Case Law 5/

United States courts will exercise jurisdiction to apply the federal securities laws to a matter that entails relatively

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3/ The Commission has defined the jurisdiction it will exercise through the adoption of rules, disclosure requirements, and special service provisions for certain non-residents engaged in the securities business in the United States, and through the issuance of "no-action" letters with respect to securities business initiated in the United States and conducted abroad. *See generally* Chapters III, V and VI.

4/ American Law Institute, Restatement of the Foreign Relations Law of the United Stated (Revised) (July 15, 1985 Tentative Final Draft) as amended by Tentative Draft No. 7 (April 10, 1986); and American Law Institute, Federal Securities Code. See discussion in Part C, *infra*.

5/ Issues concerning a court's exercise of personal jurisdiction over the parties and its choice of American law or foreign law are beyond the scope of this Report. In general, the personal jurisdiction of a United States court over a foreign party is a question of due process. *See* *World-Wide Volkswagon Corp. v. Woodson*, 444 U.S. 286 (1980); *Asahi Metal Industry Co., Ltd. v. Superior Court of California, Solano County*, 107 S. Ct. 1026 (1987). Additionally, a U.S. court may have jurisdiction over the parties, but, under choice of law principles, may choose to apply foreign law.

significant conduct within the United States, or that produces or is likely to produce relatively significant effects in the United States. 6/

These concepts are framed in two sections of the American Law Institute's Restatement (Second) of Foreign Relations Law of the United States. Section 17 states that a government may regulate (and thus a court may apply its national law to) conduct occurring and matters located in its territory. 7/ Section 18 states that a government may regulate conduct outside its territory that causes effects within the country where that conduct is generally recognized as illegal; or where the effects were foreseeable and substantial, and regulation by that government would be consonant with the law of other states. 8/ These

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6/ *See generally Laker Airways Ltd. v. Sabena Belgian World Airways*, 731 F.2d 909, 921-26 (D.C. Cir. 1984).

7/ The section reads as follows:

> § 17. Jurisdiction to Prescribe with Respect to Conduct, Thing, Status, or Other Interest Within Territory
>
> A state has jurisdiction to prescribe a rule of law
>
> (a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and
>
> (b) relating to a thing located, or a status or other interest localized, in its territory.

8/ That section reads:

> § 18. Jurisdiction to Prescribe with Respect to Effect within Territory

(footnote continued)

formulations of the "conduct" and "effects" tests of jurisdiction have strongly influenced judicial analysis of jurisdiction under the federal securities laws.

In applying these tests, particularly in the antifraud area, the courts have sought to discern Congressional intent, express or implied, with respect to the extraterritorial application of the securities laws. As a general proposition, the courts have construed the broad statutory language of the antifraud provisions of the securities laws, in light of the guidance provided by the conduct and effects tests, as indicating that Congress intended to provide comprehensive protection against fraud in the offer, purchase, or sale of securities. See Leasco Data Processing v. Maxwell, 468 F.2d 1326, 1334-37 (2d Cir. 1972).

8/ (footnote continued)

> A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either
>
> (a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or
>
> (b) (i) the conduct and its effect are constituent elements of activity to which the rule applies; (ii) the effect within the territory is substantial; (iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

1. The conduct test

It is well established that U.S. courts may assert jurisdiction over cases where a fraudulent offer was made, or a securities transaction fraudulently induced, within the United States, even if the transaction was ultimately consummated outside of the United States. However, a court may decline to exercise jurisdiction if it deems such exercise to be inappropriate in light of Congressional intent.

Leasco Data Processing

1972), is an example of a case in which the court did assert its jurisdiction even where the transactions were culminated abroad. There, the plaintiffs alleged that they had been induced to purchase securities on the London Stock Exchange by significant misrepresentations made to them in the United States. The court in that case noted that

> [c]onduct within the territory alone would seem sufficient from the standpoint of [United States] jurisdiction to prescribe the rule.

Id. at 1334 (emphasis in original). In support of its exercise of jurisdiction, the court also referred to Congressional intent to prohibit substantial misrepresentations in the United States.

In contrast, courts have declined to exercise jurisdiction where the conduct in the United States has been deemed relatively unimportant to the alleged misconduct. In Bersch v. Drexel Firestone, 519 F.2d 974 (2d Cir.), cert. denied, 423 U.S. 1018 (1975), for example, repeated and important meetings among American lawyers, underwriters, accountants, and the SEC, as well as some

drafting of the prospectus and the opening of bank accounts in the United States, were deemed sufficient to warrant the application of United States law. 519 F.2d 985, citing Section 17 of the Restatement (Second). Nevertheless, because the court determined that the United States activities were "merely preparatory," consisted merely of "culpable nonfeasance," and were small in comparison with the activities abroad, it declined to exercise that jurisdiction. 519 F.2d 987. 9/ The prospectus had been issued from London, Brussels, Toronto, the Bahamas, and Geneva, and was delivered only to purchasers outside the United States. Thus, the court found that the transactions were "predominantly foreign." Id.

In other cases, limited conduct in the United States has been viewed as significant to the scheme as a whole and thus courts have determined to exercise their jurisdiction. In Grunenthal GmbH v.

9/ With respect to some American residents who bought into the offering, the court did consider it proper to exercise jurisdiction based on the combination of conduct and effects in the United States.

Another court of appeals has stated that conduct in the United States is not "merely preparatory" when it is "'significant with respect to the alleged violations,'" and "'furthered the fraudulent scheme.'" Grunenthal GmbH v. Hotz, 712 F.2d 421, 425 (9th Cir. 1983), quoting Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, 592 F.2d 409, 420 (8th Cir. 1979). But see F.O.F. Proprietary Funds v. Arthur Young & Co., 400 F. Supp. 1219, 1222-23 (S.D.N.Y. 1975) (in which the court concluded that, despite preparatory work performed in the United States, contact with the United States was insufficient because the materially misleading information was only circulated abroad).

Hotz, 712 F.2d 421 (9th Cir. 1983), an agreement negotiated between foreign parties outside the United States was executed in Los Angeles. The court concluded that jurisdiction could be based on two material misrepresentations arising from the execution. These misrepresentations related to the authority of one of the signators and to the intentions of certain other signators to perform in accordance with the agreement.

In cases where the offer is directed outside the United States, the exercise of United States jurisdiction may depend on whether there was a preponderance of United States activity. In IIT v. Vencap Ltd, 519 F.2d 1001 (2d Cir. 1975), a London fund with predominantly foreign (but some American) investors sued a Bahamian corporation over transactions negotiated in New York. 10/ The court found it proper to exercise jurisdiction over the action because, on the facts of the case, the fraud was "concocted" in the United States. The Second Circuit stated that

> [w]e do not think Congress intended to allow the United States to be used as a base for

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10/ While 28 U.S.C. 1350 provides jurisdiction over "any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States," the court was reluctant to exercise jurisdiction under that section (even though one of the defendants was owned and controlled by a United States citizen):

> Although the United States has power to prescribe the conduct of its nationals everywhere in the world, * * *, Congress does not often do so and Courts are forced to interpret the statute at issue in the particular case.

519 F.2d at 1016 (citation omitted).

> manufacturing fraudulent security devices for export, even when these are peddled only to foreigners.

519 F.2d at 1017. This statement reflects the broad language of Section 10(b) of the Securities Exchange Act and the strong United States policy interest in prohibiting fraud. 11/

Likewise, in United States v. Cook, 573 F.2d 281 (5th Cir. 1978), cert. denied, 439 U.S. 836 (1978), the court upheld jurisdiction where a group of Americans in Texas placed false and misleading advertisements in European publications, soliciting investors in American oil ventures. The Americans signed contracts in Europe with European investors and recorded those contracts in the United States. On appeal, one of the American defendants contended that the district court could not exercise jurisdiction because the victims of the fraud were foreign. The court of appeals concluded that the facts of the case -- including activities in Dallas, the American securities, and the repatriation of funds -- were "so far within the jurisdiction as to give us little pause." 573 F.2d at 283. According to the opinion:

> That Congress would allow America to be a haven for swindlers and confidence men when the victims are European while expecting the highest level of business practice when the investors are American is "simply unimaginable."

573 F.2d at 284, citing Vencap's discussion of the export of fraud. 12/

11/ See also Bersch, 519 F.2d at 987.

12/ In IIT v. Cornfeld, 619 F.2d 909, 920 (2d Cir. 1980), jurisdiction was based on two factors: the existence of American

(footnote continued)

In employing the conduct test of jurisdiction, courts have also struggled with the problem of ascribing a location to alleged fraud consisting solely of a failure to disclose. In one such case, Continental Grain (Australia) Pty. Ltd. Pacific Oilseeds, 592 F.2d 409 (8th Cir. 1979), American defendants seeking to sell the stock of an Australian company allegedly failed to disclose

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12/ (footnote continued)

securities and conduct in the United States. In that case, a Luxembourg corporation entered into three separate transactions with an American corporation, its American affiliate, and its Netherland Antilles subsidiary. With regard to a purchase of the American parent's stock in the United States over-the-counter market, as well as a purchase of the American affiliate's note, the court had "no difficulty" in determining to exercise jurisdiction, because "these were securities of American corporations, [and] the transactions were fully consummated within the United States." Id. at 918. Although the court considered neither factor alone sufficient to exercise jurisdiction, it observed that their combination "points strongly toward applying the antifraud provisions of our securities laws." Id.

With respect to losses resulting from the Netherland Antilles subsidiary's Eurobond offering, consummated almost entirely in Europe, the court concluded that the Eurobond offering was "closely coordinated" with an offering in the United States, that the subsidiary had no operating assets, and that the American parent corporation guaranteed the Eurobond notes, which were convertible into the parent's stock. Thus, the court labelled the securities "in substance * * * American." Id. at 919-20. In addition, the court noted that the sole underwriter of the Eurobond offering was American and, "[p]erhaps most important of all," the prospectus was "wholly drafted in the United States," even to its printing, and the accounting work was performed in the United States. Id. at 920. Under these circumstances, the court stated (id.) that

> while many of the acts in the United States in this case were similar to those in Bersch, the relativity is entirely different because of the lack here of the foreign activity so dominant in Bersch * * *.

material information in communicating from the United States to the Australian buyer. The court based its exercise of jurisdiction on its conclusion that the fraud had been "devised in and completed in the United States * * * and then it was 'exported' to Australia." 592 F.2d at 420. 13/

The conduct upon which jurisdiction is premised may include not only fraudulent representations or omissions, but also acts designed to further the fraud. In SEC v. Kasser, 548 F.2d 109 (3d Cir.), cert. denied, 431 U.S. 938 (1977), the defendants allegedly defrauded a Canadian corporation, furthering the scheme through the use of the United States telephone system and mails, maintainence in the United States of records crucial to the consummation of the scheme, the use of a New York bank as a conduit for the proceeds and the execution of a key investment contract in the United States. The court considered that the totality of this conduct was not only "essential to the plan to defraud," but constituted the export of fraud warranting the exercise of United States jurisdiction. 14/ 548 F.2d 114-115.

13/ The court cited in this connection Section 17 of the Restatement (Second). Id.

14/ In a recent commodities fraud case, the plaintiff contended that he had been falsely advised, by oral communications in Athens and by written communications from New York, that his transactions on the American commodities markets would be handled by qualified managers. The alleged fraud consisted of both the initial misrepresentations and subsequent mismanagement of the account, and the commodity trades in the United States that "directly caused" the loss. The court concluded that the preparation and issuance

(footnote continued)

2. <u>The effects test</u>

An alternative basis for the exercise of subject matter jurisdiction is the impact or effect that acts have in the United States. Under this test, a court will entertain a cause of action where conduct outside the United States is deemed to significantly injure the American securities markets. That principle was first recognized in <u>Schoenbaum v. Firstbrook</u>, 405 F.2d 200, <u>rev'd on other grounds</u>, 405 F.2d 215 (2d Cir. <u>en</u> <u>banc</u> 1968), <u>cert. denied</u>, 395 U.S. 906 (1969). There the common stock

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<u>14</u>/ (footnote continued)

in New York of the broker-dealer's written description of its services, and the ultimate completion of commodity futures contracts on American exchanges, consituted a "substantial enough" contact in the United States to give the court jurisdiction over this dispute between a Greek citizen and resident and the American employer of his account executives in Athens and Paris. <u>Psimenos v. E.F. Hutton & Co.</u>, 722 F.2d 1041, 1046-48 (2d Cir. 1983). <u>See also</u> <u>Tamari v. Bache & Co., (Lebanon), S.A.L.</u>, 547 F. Supp. 309 (N.D. Ill. 1982), <u>aff'd</u>. 730 F.2d 1103, <u>cert. denied</u>, 469 U.S. 871 (1984). <u>See also</u> <u>Arthur Lipper Corp. v. SEC</u>, 547 F.2d 171 (2d Cir. 1976), <u>cert. denied</u>, 434 U.S. 1009 (deciding an antifraud action allegedly involving fraudulent and illegal kickbacks on commissions for securities transactions executed on the New York Stock Exchange and the United States over-the-counter-market, even though the only relevant misrepresentation consisted of an omission in Mexico). <u>Cf.</u> <u>Fidenas AG v. Compagnie Internationale pour l'Informatique CII Honeywell Bull, S.A.</u>, 606 F.2d 5 (2d Cir. 1979)(affirming the dismissal of an action by foreign plaintiffs against foreign defendants in which the alleged fraud and the central transactions occurred in Europe, and the only United States contacts were that some of a group of promissory notes were placed in the United States, and some of the proceeds were intended to be, but never were, used in the United States); <u>Mormels v. Girofinance, S.A.</u>, 544 F. Supp. 815 (S.D.N.Y. 1982) (dismissing a suit by an American residing in Costa Rica against a Costa Rican commodities broker because the alleged misconduct, <u>i.e.</u>, the misrepresentation, delivery, and conversion of funds, all occurred in Costa Rica).

of a Canadian corporation was registered for trading on the American Stock Exchange. The Canadian corporation's controlling shareholder, a wholly-owned subsidiary of a French company, bought 500,000 shares of the Canadian company's common stock on the Toronto Stock Exchange. Subsequently the Canadian company sold 270,000 of its shares to ten professional European investors. 15/ The complaint alleged that the French company bought the 500,000 shares on the Toronto Stock Exchange while in possession of material undisclosed information about the Canadian company's assets, and further, that affiliates of the French company bought the 270,000 shares placed in Europe.

The Second Circuit stated that because the transactions took place outside the United States, its exercise of jurisdiction was premised on specific allegations which

> involve stock registered and listed on a national securities exchange, and [transactions which] are detrimental to the interests of American investors.

Id. at 208 (citations omitted). 16/ The court found in that case that the alleged fraud on the Canadian company could "be reflected in lower prices bid for its shares on the [U.S.] market." 405 F.2d at 208. The assertion of jurisdiction was warranted because the conduct in Canada,

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15/ 405 F.2d at 205.

16/ The court construed Section 30(b), 15 U.S.C. 78dd, providing an exemption from the Securities Exchange Act for "business in securities without the jurisdiction of the United States," to be limited to foreign transactions by persons "in the securities business" such as broker-dealers. 405 F.2d at 207-08.

> allegedly in violation of the [Securities Exchange] Act, has * * * a sufficiently serious effect upon United States commerce * * *.

Id. at 209 (citations omitted).

The magnitude of effect in the United States may be determinative of the exercise of jurisdiction. Compare Des Brisay v. Goldfield Corporation, 549 F.2d 133, 136 (9th Cir. 1977) (upholding jurisdiction where the takeover of a Canadian corporation effected in Canada by an American corporation whose stock was listed on the American Stock Exchange violated the Securities Act and proximately caused the collapse of the American market in the American company's shares) with Bersch v. Drexel Firestone, supra, 519 F.2d at 988 (where "generalized effects" on the American market were held insufficient to confer subject matter jurisdiction over a damage suit by a foreigner when the fraudulent conduct was alleged to have occurred abroad and there was no intention that the securities would be offered to anyone in the United States).

Moreover, jurisdiction may be based on the combination of some United States conduct and specific detrimental effects on American residents or citizens. Indeed, the court in Bersch reasoned that a sufficient injury to such persons minimized the amount of United States conduct necessary for the assertion of jurisdiction:

> While merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad, they are sufficient when the injury is to Americans so resident.

519 at 992. 17/ Thus, in that case, where almost 400 Americans purchased securities at the offering price of $10 and the securities were "virtually unsaleable" within a few weeks (519 F.2d at 981), the court exercised jurisdiction based upon the combination of the conduct in the United States and the injury to American citizens abroad. 519 F.2d at 992. The court relied in this connection on Section 18 of the Restatement (Second). 18/

As the discussion in many of these decisions demonstrates, the U.S. courts may have a basis on which to exercise jurisdiction over a controversy, but nonetheless may determine not to do so.

17/ Although the authority to regulate and protect a country's nationals, even outside of the state, is a long-recognized basis of jurisdiction (see, e.g., Restatement (Second) of the Foreign Relations Law of the United States, Section 30 (1965); Restatement of Foreign Relations Law of the United States (Revised), Section 402(2) (July 15, 1985 Tentative Final Draft)), the nationality-based distinction drawn in Bersch between non-resident victims has been criticized as constitutionally suspect for denying equal protection to aliens (see Continental Grain v. Pacific Oilseeds, Inc., 592 F.2d 409, 418 n.14 (8th Cir. 1979)).

18/ The court in Bersch separately recognized that jurisdiction could have been premised on effects in the United States if there had also been some United States conduct, such as false prospectuses mailed into the United States, or alternatively, if the value of the shares in the United States market was depressed by fraud committed abroad. 519 F.2d at 988-89. Other cases that have weighed the magnitude of United States effects as a test for jurisdiction include Vencap, 519 F.2d at 1016 (rejecting the argument that fraudulent activities abroad had significant effect in the United States simply because the victims of the fraud included some United States citizens or residents whose exposure amounted only to "some .5% of the total [investment]") and Continental Grain, 592 F.2d at 417 (rejecting as "too remote" an effects-based jurisdictional approach premised on the loss produced on the books of the plaintiff's American parent).

The courts have frequently referred to considerations beyond mere weighing of the facts in order to decide the significance of the United States interest. 19/ One major policy factor has been the courts' distaste for the "export of fraud." IIT v. Cornfeld, 619 F.2d at 920. A countervailing one has been a reluctance to construe Congressional intent so broadly as to reach all securities transactions that have some American component or relationship, however trivial. Thus, the Second Circuit has cautioned

> the language of § 10(b) * * * is much too inconclusive to lead us to believe that Congress meant to impose rules governing conduct throughout the world in every instance where an American company bought or sold a security.

Leasco, 468 F.2d at 1334 (emphasis supplied).

Sections 17 and 18 of the Restatement (Second) have been utilized by the courts in identifying policy considerations that bear on the determination to exercise jursidiction in federal securities cases. Their suitability to the federal securities laws is demonstrated by recent scholarly commentary in matters of international securities jurisdiction, which generally defers to the jurisdictional analyses the courts have developed under the Restatement (Second) in cases arising under the federal securities laws.

19/ The court in Continental Grain, "frankly admit[ted] that * * * [its jurisdictional determination] is largely a policy decision." Nonetheless, it observed that, under Section 10(b), "[t]he range of significant conduct should * * * be fairly inclusive," citing "the general purpose of the securities laws to mandate the highest standards of conduct * * *." Id. 592 F.2d at 421. Accord, Leasco, 468 F.2d at 1336.

C. Recent Work On Federal Securities Jurisdiction

The American Law Institute has recently issued two documents that address the international limits of jurisdiction under the federal securities laws. The discussion in the Federal Securities Code is based upon the authorities cited in Part E, supra, and focuses upon subject matter jurisdiction as the concept has developed in the area of federal securities regulation. The Restatement of the Foreign Relations Law of the United States (Revised) (July 15, 1985 Tentative Final Draft), as amended by Tentative Draft No. 7 (April 10, 1986) 20/, is designed, according to its Reporters, to suggest the direction in which all domestic and international law should develop. The Restatement (Revised) also discusses jurisdiction of securities laws cases in the context of the considerable body of law that United States courts have developed in this area. However, because of the different approaches, the conclusions of the two documents are somewhat different.

1. The Federal Securities Code

Fundamentally, the Federal Securities Code provides broader international jurisdiction over fraud than jurisdiction for other activities addressed by the federal securities laws. Section 1905 (a)(1)(A) provides that the Code is applicable to purchases, sales or offers to buy or sell securities, proxy solicitations, tender

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20/ The Revised Restatement was adopted by the ALI at its May, 1986 annual meeting. As of the date of this Report, no final version of the Revised Restatement has been published.

offers, and activity as an investment adviser occurring "within the United States although * * * initiated outside the United States." Section 1905(a)(2), which adopts essentially the "export of fraud" theory, would apply the Code's antifraud provisions to offers, purchases and sales, proxies, tender offers, and activity as an investment adviser initiated in this country but occurring elsewhere. Under Section 1905(a)(1)(B), the Code would apply to such nonresidents who have an identifiable status to which the Code attaches legal significance, without regard to the existence of conduct in the United States. This status includes registrants, officers, directors, and shareholders subject to Sections 13, 14(a), and 16 of the Securities Exchange Act, and banks and participants in registered clearing agencies.

2. The Revised Restatement.

The Revised Restatement is premised upon a balancing test, labelled "reasonableness." This test would require an American court, before exercising jurisdiction, to consider eight factors, including conduct and effect. 21/ These factors were derived

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21/ These factors are set forth in Section 403(2):

(a) the extent to which the activity (i) takes place within the regulating state, or (ii) has substantial, direct, and forseeable effect upon or in the regulating state;

(footnote continued)

almost exclusively from case law in the antitrust area, see note 2 to Section 403, and are, in many instances, irrelevant or unhelpful in cases alleging violations of the federal securities laws. Earlier drafts of the revision applied these factors uncritically to cases involving the federal securities laws.

In October 1984, the Commission's General Counsel submitted extensive comments to the ALI with respect to the Revised

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21/ (footnote continued)

(b) the connections such as nationality, residence, or economic activity, between the regulating state and the persons principally responsible for the activity to be regulated, or between that state and those whom the law or regulation is designed to protect;

(c) the character of the activity to be regulated, the importance of regulations to the regulating state, the extent to which other states regulate such activities and the degree to which the desirability of such regulation is generally accepted;

(d) the existence of justified expectations that might be protected or hurt by the regulation in question;

(e) the importance of the regulation in question to the international political, legal or economic system;

(f) the extent to which such regulation is consistent with the traditions of the international system;

(g) the extent to which another state may have an interest in regulating the activity; and

(h) the likelihood of conflict with regulation by other states.

Restatement, strongly criticizing the reasonableness test as vague and uncertain. By contrast, he pointed to Section 1905 of the Federal Securities Code as a straightforward restatement of current law and practice. Both the Attorney General and the Legal Adviser to the Department of State also submitted comments to the ALI on the Revised Restatement. Although the focus of their comments varied from those of the Commission's General Counsel, each also observed that the reasonableness test neither represented current law nor necessarily improved upon the fundamental premise of current law, which is comity i.e., "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience and to the rights of its own citizens or of other persons who are under the protection of its laws * * *." Hilton v. Guyot, 159 U.S. 113 (1895).

After receiving the General Counsel's comments, the Reporters of the Revised Restatement met several times with the Commission's staff to discuss ways to improve the Restatement's approach to the securities laws. Some of the changes subsequently made in Revised Restatement Section 416 reflect these discussions. While the Commission's General Counsel would have approached the matter differently, the new Section 416(1) attempts to state general principles derived from existing case law, and to set forth in Section 416(2) particular principles relevant to the securities laws to guide the application of the Section 403 factors.

Section 416 in its present form has two principal parts. 22/ The section recognizes United States jurisdiction with respect to

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22/ Section 416 reads as follows:

> Jurisdiction to Regulate Activities related to Securities: Law of the United States.
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> (1) The United States generally has jurisdiction to prescribe with respect to
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> (a) (i) any transaction in securities in the United States to which a national or resident of the United States is a party, and
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> (ii) any offer to enter into a securities transaction, made in the United States by or to a national or resident of the United States;
>
> (b) any transaction in securities
>
> (i) carried out, or intended to be carried out, on an organized securities market in the United States, or
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> (ii) carried out, or intended to be carried out, predominantly in the United States, although not on an organized securities market;
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> (c) conduct, regardless of where it occurs, significantly related to a transaction described in Subsection 1(b), if the conduct has, or is intended to have, a substantial effect in the United States;
>
> (d) conduct occurring predominantly in the United States that is related to a transaction in securities, even if the transaction occurs outside the United States; and

(footnote continued)

offers or transactions in securities made or carried out predominantly in the United States, or by or to an American national or resident, as well as with respect to situations involving substantial effect in the United States or conduct occurring predominantly in the United States. The general descriptions contained in Section 416(1), which recognizes United States jurisdiction without reference to further factors, are derived from the case law under the conduct test, including Leasco,

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22/ (footnote continued)

(e) investment advice or solicitation of proxies or of consents with respect to securities, carried out predominantly in the United States.

(2) The jurisdiction of the United States to apply its securities laws to transactions or conduct other than those addressed in Subsection (1) depends on whether it is reasonable to do so in the light of § 403, giving particular weight to

(a) whether the transaction or conduct has, or can reasonably be expected to have, a substantial effect on a securities market in the United States for securities of the same issuer or on holdings in such securities by United States nationals or residents;

(b) whether representations are made or negotiations are conducted in the United States; and

(c) whether the party sought to be subjected to the jurisdiction of the United States is a United States national or resident, or the persons sought to be protected are United States nationals or residents.

Bersch, Continental Grain, Vencap, Cook, Cornfeld, Kasser, Psimenos, and Lipper. Section 416(1) also reflects the holdings under the effects test in Des Brisay and Bersch. For all other matters, the section would require reference to the eight factors in Section 403, with "particular weight" given to substantial effects on United States securities or holdings, representations or negotiations conducted in the United States, and the interest of the parties in obtaining protection under United States law. The section makes no attempt to replicate the distinctions drawn in the Code between antifraud jurisdiction on the one hand and status jurisdiction on the other.

Section 416(2)(a) of the Revised Restatement deals with the "effects" line of cases under Schoenbaum. That section provides that in determining the existence of jurisdiction for such cases weight should be given to various enumerated factors, including substantial effect or potential effect in the United States market.

Section 416 of the Revised Restatement as approved by the ALI now recognizes and builds upon the major decisions on subject matter jurisdiction in the federal securities area. By emphasizing in Section 416(2) the considerations most important to a securities case, the new section now also avoids the pitfall of applying law that is, as termed in AVC Nederland, B.V. v. Atrium Investment Partnership, 740 F.2d 148, 154-55 (2d Cir. 1984), "inapplicable, dubious or neutral" to jurisdiction under the securities law.

II. INVESTIGATING POSSIBLE VIOLATIONS OF THE U.S. SECURITIES LAWS

A. Introduction

Where activities involving securities come within the jurisdictional ambit of the U.S., either because conduct has taken place in this country or because the activities have had an effect on U.S. markets, the staff of the Commission may find it necessary to investigate possible violations of the securities laws. The Commission has broad statutory authority to conduct investigations to determine whether a violation of the federal securities laws has occurred or is about to occur. Most enforcement actions are preceded by a private investigation. The sources and types of information sought in international investigations are much the same as those in domestic investigations, and, as discussed *infra*, the Commission employs many of the same mechanisms to obtain information. However, because of limitations in the Commission's jurisdiction and the interposition of blocking and secrecy laws by other nations, the Commission has found it necessary to develop other means to obtain evidence located abroad, including bilateral agreements for cooperation in enforcement efforts.

B. Methods for Obtaining Information

1. Voluntary Cooperation

During the preliminary stages of an investigation, the Commission's staff may request information from persons or entities on a voluntary basis. For example, routine trading information from broker-dealers and general corporate information from public

and private companies is often obtained in this manner. In international investigations, even where the desire to provide information voluntarily exists, foreign blocking and secrecy laws may prevent such cooperation.

2. Administrative subpoenas

Where voluntary compliance is not forthcoming, or does not yield needed information, the Commission has the power, under the securities laws, to issue subpoenas compelling the production of documents and testimony relevant to the areas of Commission inquiry. Those same laws give a federal district court the power to order compliance with a Commission investigatory subpoena in the case of a refusal to obey the subpoena without good cause. The Commission is authorized to subpoena witnesses "from any place in the United States." 23/ This statutory language commonly employed in the laws governing most American regulatory agencies, has been construed by U.S. courts to be a broad and flexible authorization to compel the production of evidence

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23/ Securities Exchange Act Section 21, 15 U.S.C. 78u(b), gives the Commission the authority to

> subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

See also Section 19(b), Securities Act of 1933, 15 U.S.C. 77s(b); Section 42(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-41; and Section 209(b) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-9.

from anywhere in the world, so long as service has been properly effected in the U.S.

In the first challenge to the Commission's use of administrative subpoenas to obtain records from outside of the United States, SEC v. Minas de Artemisa, S.A., 150 F.2d 215 (9th Cir. 1945), the court ordered a Mexican company to produce books and records pursuant to a Commission administrative subpoena served on the company's president, an American citizen, at his residence in Arizona. The subpoena was directed to the Mexican company and sought documents maintained in Mexico and required by Mexican law to be kept there. When the president refused to comply, the Commission sought enforcement in district court. The district court dismissed the Commission's application.

The court of appeals reversed. The Ninth Circuit concluded that the district court in Arizona had personal jurisdiction over the Mexican company, and that the statutory language governing the issuance of administrative subpoenas gave the Commission authority

> to require the attendance of witnesses or the production of documentary evidence at any designated place of hearing, provided only that service of the subpoena is made within the territorial limits of the United States.

150 F.2d at 218. 24/

24/ In the face of evidence that Mexican law prohibited the removal of certain corporate records from the country, but

(footnote continued)

Except as provided by statute, United States administrative agencies do not have the power to compel persons outside the U.S., who have no contact with the U.S. (and who therefore are not under a federal court's jurisdiction), to produce evidence for an investigation. 25/ Foreign brokers who trade on American exchanges and are registered with the Commission are subject to Commission subpoenas concerning securities trading because they are required by Commission rule to appoint the Secretary of the Commission as their agent for service.

3. Discovery During Civil Litigation

If a Commission investigation results in a case which is inappropriate for resolution administratively, and U.S. courts

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24/ (footnote continued)

did not prohibit production of books and records in Mexico itself, the court ordered the company to apply to Mexican authorities for authorization to remove the books. In the event that authorization was not permitted, the court ordered that the company allow the Commission to inspect the books in Mexico and provide authenticated copies of any records requested pursuant to that inspection. *Id.* at 218-19.

25/ The Federal Trade Commission and the Internal Revenue Service have been expressly authorized to serve investigative demands in foreign states in a manner parallel to the service of process provisions of Rule 4 of the Federal Rules of Civil Procedure. *See*, 15 U.S.C. 57b-1 (F.T.C.) and 26 U.S.C. 982 (I.R.S.). On October 17, 1986, in a bill extending funding authority for the Commodity Futures Trading Commission, Congress provided the CFTC with authority to serve subpoenas on persons resident outside the United States in connection with fraud or market manipulation cases.

have personal jurisdiction over the defendant, the Commission may file a lawsuit in federal district court for violation of the federal securities laws. In such civil actions, the Commission may obtain information through pre-trial discovery such as depositions, interrogatories and document requests. If parties to an action fail to respond to requests for discovery, the Commission may move for a motion to compel discovery pursuant to Rule 37 of the Federal Rules of Civil Procedure.

In many cases, these procedures have proven efficacious in international investigations. In others, however, the Commission's ability to obtain information located abroad has been limited. Foreign blocking and secrecy laws have presented particularly difficult obstacles in some cases.

4. Blocking Statutes

Blocking statutes enable foreign governments to prohibit or control the distribution of information outside the territorial boundaries of the state. 26/ Blocking laws reflect a legislative decision to protect certain types of information -- most often related to international commerce or trade, national security and economic matters. They often prohibit even voluntary disclosure of information to foreign states and provide civil and criminal penalties for violations.

Blocking statutes vary, depending on the interest which states perceive in information located within their borders.

26/ Countries with blocking statutes include France, the United Kingdom, Canada (Ontario), and Switzerland.

As examples, three statutes are described below.

The Canadian Foreign Extraterritorial Measures Act (Statutes of Canada 1984-1985, C.49) authorizes the Attorney General of Canada to prohibit disclosure of information from Canada, to seize records, to require a person in Canada to give him notice of foreign court compulsion, and to prohibit that person from complying with orders of foreign courts. In order to invoke these powers, the Attorney General must determine that a foreign state or a foreign tribunal has taken or is proposing to take measures affecting international trade or commerce that will adversely affect significant Canadian interests in relation to international trade or commerce involving business carried on in whole or in part in Canada, or that would otherwise infringe Canadian sovereignty. The Act provides for criminal sanctions for failure to comply.

The United Kingdom's Protection of Trading Interests Act ("PTI") of 1980 authorizes its Secretary of State to require a person doing business in the United Kingdom to give notice of any foreign compulsion and to direct that person's response to such compulsion. Like the Canadian statute, it prohibits domestic courts from complying with proscribed foreign orders, and provides criminal sanctions against persons who violate the Act. It differs from the Canadian law in its greater specificity of the actions against which it is directed, but has a similar standard for objectionable foreign conduct.

The effect of the PTI was extended by Parliament in the Financial Services Act of 1986, which provides that the Secretary of State may block the production of documents even where such documents are being provided on a voluntary basis. This provision appears to be a direct response to the approach developed by the Commission whereby stock exchanges agreed, as a matter of contract, to provide each other with access to their files with the understanding that this information could be passed on to regulatory authorities.

The French Law, No. 80-538 of July 16, 1980, forbids French nationals, and certain others with ties to France, from communicating economic, commercial, industrial, financial or technical matters to foreign authorities except as provided by treaty or international agreement. It also prohibits requests for economic, commercial, industrial, financial, or technical information or documents to be used directly or indirectly for proof in court or administrative tribunals, except as provided by treaty or international agreement. Unlike the British and Canadian statutes, the French statute is automatic, and virtually universal in scope.

One decision which evaluated the effect that U.S. courts will give the French statute is Graco, Inc. v. Kremlin, Inc., 101 F.R.D. 503 (N.D. 111. 1984). In Graco, the court observed that:

> compliance with U.S. discovery, even if ultimately effected in the United States, necessarily would involve some activity in France,

> such as gathering documents or information. * * * [Thus], it would not be possible * * * to avoid * * * [the French blocking statute] completely by effecting * * * compliance outside France.

101 F.R.D. at 510. The court also concluded that treaties and international agreements were unavailing to avoid the confict. 27/

5. Secrecy Laws

Secrecy laws establish rights by which individuals may require others to keep secret specific information. 28/ Like blocking statutes, secrecy laws take a variety of forms. They range from statutes that create fiduciary relationships, subject to waiver only by the principal, to statutes investing private confidentiality with a state interest. Two examples of secrecy laws are described below.

Switzerland has both civil and criminal provisions governing secrecy. Banking secrecy is an aspect of the fiduciary relationship between the bank and its customer under Swiss civil law. It extends to any communication with the customer, even where the information concerns third parties. The customer may waive secrecy; the bank will then provide the customer any evidence in its possession for the customer to produce in foreign courts.

27/ The French statute also was at issue in Societe Nationale Industrielle Aerospatiale v. U.S. District Court for the Southern District of Iowa, 96 L.Ed. 2d 461.

28/ Countries with secrecy laws include Switzerland, the Cayman Islands, the Bahama Islands, Lichtenstein and Panama.

In addition, the Swiss Penal Code provides sanctions for persons associated with banks who breach client confidentiality. Similarly, criminal sanctions are available against individuals who disclose manufacturing or business secrets. Most of the criminal provisions characterize the interest in secrecy as being personal to the parties; however, one provision of the Swiss Penal Code describes the release of Swiss banking, manufacturing, or business secrets to a foreign authority as an offense against the state. This provision is inapplicable if the principal is not Swiss. In the event of a refusal by a Swiss principal, secrecy may be waived by a Swiss court.

Two cases illustrate the application of Swiss secrecy law in a U.S. investigation into possibly illegal trading on non-public information. In SEC v. Banca Della Svizzera Italiana, et al., 92 F.R.D. 111 (S.D.N.Y. 1981) (the "St. Joe case"), the Commission was attempting to learn identities of a Swiss bank's customers who had purchased common stock and options in St. Joe Minerals Corp. securities the day before the announcement by Joseph E. Seagrams & Sons, Inc. of a proposed tender offer for all the outstanding shares of that company at a $14 per share premium.

The Commission obtained a temporary restraining order from the federal district court freezing profits derived from the transactions at the U.S. office of Banca Della Svizzera Italiana ("BSI"), the Swiss bank through which the original order had

been placed, based upon: (a) the circumstances of the transac- tions; (b) the Commission's inability to learn the identity of the purchaser(s); and (c) the need to prevent the profits gained as a result of the allegedly violative transactions from leaving the jurisdiction of a U.S. court. The bank refused to respond to interrogatories or to reveal its customers' identit

The Commission moved for an order to compel discovery under Rule 37 of the Federal Rules of Civil Procedure. BSI countered that such disclosure would violate Swiss secrecy laws and subject it to civil and ciminal liability in Switzerland. After a hearing on the matter, on November 6, 1981, the court granted the Commission's motion and ordered BSI to disclose its its customer's identities. SEC v. Banca Della Svizzera Italian 92 F.R.D. 111, 113, (S.D.N.Y. 1981). Before the court order wa signed, BSI obtained a waiver of Swiss secrecy laws from its customers and responded to the Commission's interrogatories. 2

In SEC v. Musella, et al., 83 Civ. 342 (S.D.N.Y. 1983), the Commission obtained a court order compelling a witness to waive Swiss bank secrecy. Shortly after the insider trading suit against Musella was filed, the Commission wrote to counsel

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29/ The information obtained as a result of the court's decisi on the discovery request against BSI ultimately contribute to the Commission's successful action against the foreign purchasers of St. Joe securities in SEC v. Tome, discussed supra.

for Musella requesting that he waive all bank secrecy protections extended by any foreign jurisdiction, including Switzerland. The Commission never received a response to this request. Accordingly, at a deposition the Commission presented Musella with a waiver of all Swiss bank secrecy protections and asked him to sign it. He refused. Thereafter, the Commission sought disclosure of the account information from Musella's Swiss bank, which claimed that Swiss bank secrecy laws prevented its cooperation. The court granted a motion by the Commission to direct Musella to sign the waiver, rejecting his claim that he was protected against such an order by the Fifth Amendment to the U.S. Constitution, which prohibits the compulsion of self-incriminating statements. Musella still refused to sign the secrecy waiver, and, on October 6, 1983, the court held Musella in civil contempt and granted the Commission's motion to draw on adverse factual inference "to the effect that the defendant has an account at Credit Suisse [the Swiss bank]." The court ordered that this inference may be "cured" should Musella agree to permit "appropriate inquiries to be made in Switzerland by the Commission."

When Musella refused to permit such inquiries, the Commission sought the assistance of the Swiss government under the Treaty Regarding Mutual Legal Assistance in Criminal Matters (discussed infra). In June of 1984, Musella was killed in a car accident, without having signed the waiver. The Swiss

Supreme Court ultimately decided that Swiss secrecy laws would not protect the financial privacy of a dead person.

The Bahamas Banks and Trust Companies Regulation (Amendment) Act, 1980 provides for bank secrecy. Persons associated with banks licensed to conduct business in the Bahamas shall not, without the express or implied consent of the customer concerned, disclose to any other person "information relating to the identity, assets, liabilities, transactions [or] accounts of a customer" except under certain enumerated circumstances, e.g., when a bank is lawfully required to make disclosure by any court of competent jurisdiction within the Bahamas or under the provisions of any law of the Bahamas. Disclosure of information without customer authorization or other approval as specified in the Act may result in criminal penalties.

6. The Restatement (Second)

The Restatement (Second) of Foreign Relations Law of the United States, in Section 40, 30/ addresses the appropriateness

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30/ Section 40 reads as follows:

> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as
>
> (a) vital national interests of each of the states,

(footnote continued)

of a state's exercise of jurisdiction where such an exercise might require conduct inconsistent with the law of a foreign state. The section permits the United States, and its courts, to require a party subject to the jurisdiction of another state to commit an act that may violate the law of the other state if, upon consideration of five separate factors, it is appropriate to do so. This section has been particularly useful in resolving discovery disputes where the foreign state is alleged to restrict production of requested evidence.

For example, in In re Westinghouse Electric Corporation Uranium Contract Litigation, 563 F.2d 992 (10th Cir. 1977), a Canadian company had complied in part with a civil subpoena, but had refused to produce certain evidence on the ground that production would violate Canadian criminal law. The district court held the company in contempt. The Ontario Supreme Court had previously declined to enforce letters rogatory seeking

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30/ (footnote continued)

> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
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> (c) the extent to which the required conduct is to take place in the territory of the other state,
>
> (d) the nationality of the person, and
>
> (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

some of the same records because, _inter alia_, enforcement would violate a Canadian public policy statement. _Id_. at 995. The Canadian company subsequently attempted formally to obtain the permission of Canadian authorities to release the requested evidence, but was unsuccessful. _Id_. at 998. The Tenth Circuit, citing Section 40 of the Restatement (Second), concluded that "Canada has a legitimate interest in the disclosure of these documents * * *." _Id_. at 999. Accordingly, that court reversed the order of contempt and vacated the sanctions.

In contrast, in _United States v. First National City Bank_, 396 F.2d 897 (2d Cir. 1968), the Second Circuit held that West German interests were not entitled to control when the West German government had taken no interest in the discovery, would not allow bank secrecy to block its own criminal investigations, and had not even been approached for protection in the case. There, an American bank contended that it could not produce documents maintained by its foreign branch in West Germany to a grand jury because such production would expose the branch bank to civil liability under German law. However, its good faith was questionable. 31/ After carefully reviewing the factors

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31/ The bank had failed to produce documents subject to the subpoena that would _not_ expose it to civil liability under German law. Moreover, one of the companies subject to the grand jury investigation was also incorporated in New York. Compare _United States v. First National Bank of Chicago_,

(footnote continued)

set forth in Section 40, and determining that many appeared equally weighted for and against enforcement of the grand jury subpoena, the court concluded that

> [i]f indeed City Bank might suffer civil liability under German law in such circumstances, it must confront the choice -- * * * the need to "surrender to one sovereign or the other the privileges received therefrom" or, alternatively a willingness to accept the consequences.

Id. at 905 (citation omitted).

The application of these principles in the context of the securities law is illustrated by SEC v. Banca della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981), discussed supra. The court's decision in that case turned on the bank's apparent lack of good faith, as well as the Section 40 balancing test, with particular emphasis on the relative significance of the legal interests of the United States and Switzerland. The court

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31/ (footnote continued)

699 F.2d 341 (7th Cir. 1983), in which the court held that an American bank, which provided general descriptive information in response to a tax summons regarding an account maintained in Greece, but which declined to provide exact account information on the ground that criminal penalties could be levied against its Greek employees, may have acted in good faith. That matter was remanded to the district court for consideration of whether it should issue an order requiring the bank to make a good faith effort to receive permission from the Greek authorities to comply with the summons.

observed that, while the use of secret foreign bank accounts and secret foreign financial institutions had "eviscerate[d] the United States interest in enforcing its securities laws * * *", the Swiss government had expressed no opposition to the requested disclosure in the circumstances of that particular case. Id. at 117-18. On this basis the court concluded

> [i]t would be a travesty of justice to permit a foreign company to invade American markets, violate American laws if they were indeed violated, withdraw profits and resist accountability for itself and its principals for the illegality by claiming their anonymity under foreign law.

Id. at 119.

7. The Restatement (Revised)

The Restatement (Revised) of Foreign Relations Law also addresses discovery practices in Section 437. Although the proposed Section 437, like Section 416, attracted considerable criticism from government commentators, the Reporters made only one clarification in response to governmental criticism that the Section suggests unilateral revisions to the Federal Rules of Civil Procedure: to allow governmental agencies so empowered by Congress to continue to unilaterally exercise their investigatory subpoena power. Originally, the Reporter proposed to override Congressional intent by requiring all agencies to seek court approval for subpoenas for information located abroad.

The principal change that the Section proposes to state and federal rules of procedure is to require all litigation

discovery requests for information located abroad to be issued by the court, rather than by the parties. In addition, the agency or court issuing the discovery or request order would be required before issuance to undertake a special analysis. 32/ The analysis is described as patterned on the provision in

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32/ The Section reads as follows:

Section 437[420]. Discovery and Foreign Government Compulsion: Law of the United States

(1) (a) Subject to Subsection (1)(c), a court or agency in the United States, when authorized by statute or rule of court, may order a person subject to its jurisdiction to product documents, objects, or other information relevant to an action or investigation, even if the information or the person in possession of the information is outside the United States.

(b) Failure to comply with an order to produce information may subject the person to whom the order is directed to sanctions, including finding of contempt, dismissal of a claim or defense, or default judgment, or may lead to a determination that the facts to which the order was addressed are as asserted by the opposing party.

(c) In issuing an order directing production of information located abroad, a court or agency in the United States should take into account the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the United States; the availability of alternative means of

(footnote continued)

Rule 26(b)(1) of the Federal Rules of Civil Procedure that allows a court to restrict discovery which is unreasonably burdensome. 33/

32/ (footnote continued)

> securing the information; and the extent to which non-compliance with the request would undermine important interests of the United States, or compliance with the request would undermine important interests of the state where the information is located.
>
> (2) If disclosure of information located outside the United States is prohibited by a law, regulation, or order of a court or other authority of the state in which the information or prospective witness is located, or of the state of which the prospective witness is a national,
>
> (a) the person to whom the order is directed may be required by the court or agency to make a good faith effort to secure permission from the foreign authorities to make the information available;
>
> (b) sanctions of contempt, dismissal, or default should not ordinarily be imposed on the party that has failed to comply with the order for production, except in cases of deliberate concealment or removal of information or of failure to make a good faith effort in accordance with paragraph (a);
>
> (c) the court or agency may, in appropriate cases, make findings of fact adverse to a party that has failed to comply with the order for production, even if that party has made a good faith effort to secure permission from the foreign authorities to make the information available and that effort has been unsuccessful.

33/ *See* Comment a to Section 437.

These provisions are a significant departure from current law, as embodied in Section 40 of the Restatement (Second). Section 40 of the Restatement (Second) is only applicable in the event of a conflict with foreign law. By contrast, Section 437 of the Restatement (Revised) requires no conflict and presumes that all United States discovery of information outside the country from a person subject to the jurisdiction of a U.S. court, even a party litigant, is burdensome and requires limitations. Section 40 of the Restatement (Second) sets forth factors designed to determine the significance in the particular litigation of objections based upon conflicts with foreign law; it places the burden of showing the conflicts and their importance on the objecting party. Section 437 of the Restatement (Revised), instead, implies a shift in the law by placing a significant burden upon the requesting party to make an extraordinary showing in support of its request.

The Reporters suggest that this comprehensive approach restricting all discovery is appropriate because United States document discovery "has given rise to so much friction * * *," stemming both from foreign "dislike of substantive aspects of enforcement of American law * * *," and from "a difference in civil and criminal procedure between the United States and many foreign states." 34/ Section 437, thus, abandons at the

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34/ Reporters' Note 1 to Section 437.

outset the mechanisms for civil discovery contained in the Federal Rules of Civil Procedure, and their state analogues, and requires the court to determine how it would be most politic to apply United States discovery.

In his comment on the Restatement (Revised), the Attorney General of the United States observed that the Revision would usurp the power of the Congress and the Executive to the extent that it would require the courts to make political decisions that substantive or procedural American law should be restricted or not be followed, even if completely applicable. 35/

C. Agreements for the Production of Evidence

During the last several years, the Commission has successfully used existing private agreements, treaties and understandings with foreign countries to complete several of the most significant insider trading cases in the Commission's history. In addition, the Commission has been actively involved in negotiating new agreements with foreign countries to obtain their cooperation in the Commission's enforcement efforts and has participated in programs encouraging greater multinational cooperation in securities law enforcement.

35/ In a letter to the ALI dated November 26, 1985, the Attorney General stated that such choices to waive appropriate United States law "would require U.S. courts to make political decisions, which the U.S. courts are prohibited from doing under the Constitution and which * * * courts are particularly unqualified to make."

1. Private Agreements for the Production of Evidence

Intermarket Linkages 36/

As discussed in Chapter V, *supra*, a number of intermarket linkages and agreements facilitating transnational trading have been established recently. In this regard there has been concern to ensure that these agreements provide protections for U.S. investors and the integrity of U.S. markets. In reviewing rule changes of national securities exchanges developing electronic linkages, for example, the Commission has ensured that adequate arrangements have been made for market surveillance and information sharing for law enforcement purposes.

The experience with Canada demonstrates this process. The Commission's staff has worked closely with the Canadian Provincial securities authorities to develop private contractual agreements between the exchanges providing for cooperation and active sharing of information, and with the Provincial regulatory authorities to provide further assurance of cooperation in enforcement investigations. For example, the Boston Stock Exchange and Montreal Stock Exchange have agreed to cooperate in the investigation of any questioned trades, and to transfer investigatory information to each other or to either governing regulatory authority. The American Stock Exchange and the Toronto Stock Exchange have also agreed to exchange trade and

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36/ Market linkages and attendant surveillance and information sharing agreements are discussed more fully in Chapter V.

market data, and to cooperate in the investigation of any questions arising out of transactions through the linkage.

In addition, the Toronto Stock Exchange and the Ontario Securities Commission have formally assured the Commission's staff that the recently-enacted Canadian blocking statute would not hinder the sharing of information. The Director of the Ontario Securities Commission ("OSC") stated in a letter dated September 24, 1985, to the Directors of the Commission's Divisions of Enforcement and Market Regulation:

> It is extremely unlikely that an order will be issued to prohibit the exchange of information between the OSC and SEC. As insider trading and market manipulation are offences under the Securities Act (Ontario) or the Criminal Code (Canada), it is extremely unlikely that the Canadian Government would have any interest in protecting those who have engaged in such trading. It is important to note that the [Canadian] Federal Government, in enacting the legislation, described it as a "mechanism of last resort" and "clearly designed to protect national sovereignty in exceptional cases." It is difficult to conceive of an insider trading, market manipulation, or other case of improper trading that would fall into that category * * *.

Consents to Jurisdiction

The Commission recently has imposed compliance with the securities laws on foreign entities as a condition of transacting business in U.S. securities markets. The Commission recently granted an exemption from the broker-dealer registration requirements of Section 15(a)(1) of the Securities Exchange Act to certain foreign securities subsidiaries of Citicorp, a U.S. bank holding company. 37/ This exemption, issued on August 14, 1986, was

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37/ See discussion in Chapter V, supra.

specifically conditioned on representations that information with respect to the trading activities of any foreign securities subsidiary will be provided to the Commission upon request. Further, in the event that the Commission requests information regarding trading activity by a customer of a foreign securities subsidiary, Citicorp has undertaken to use its best efforts to obtain, or cause the foreign subsidiary to obtain, the consent of the customer authorizing provision of the requested information to the Commission. The exemption was also conditioned on the representation that Citicorp will cause a U.S. subsidiary to be designated as an agent for service of process.

2. Treaties

The U.S. has four treaties for mutual assistance in criminal matters. The Treaty between the U.S. and the Swiss Confederation on Mutual Assistance in Criminal Matters, 27 UST 2019, done on May 25, 1973 (effective 1977), the Treaty on Mutual Legal Assistance with the Kingdom of the Netherlands, done on June 12, 1981, TIAS 10734, the Treaty with the Republic of Turkey on Extradition and Mutual Assistance in Criminal Matters, done on June 7, 1979, TIAS 9891, and the Treaty Between the U.S. and the Italian Republic on Mutual Assistance in Criminal Matters, Sen. Ex. 98-25, 98th Cong. 2d Sess. The United States has concluded negotiations of mutual assistance treaties in criminal matters with Colombia, Morocco, Canada and the Cayman Islands; however, they have not yet entered into force.

The Swiss Treaty

The 1977 Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States was the first mutual assistance treaty of its kind to which the U.S. was a party. It provides for broad assistance in criminal matters, including assistance in locating witnesses, obtaining statements and testimony of witnesses, production and authentication of business records, and service of judicial and administrative documents.

The Treaty is available only to the governments of the U.S. and Switzerland and is supplemented by six exchanges of letters interpreting certain language used in the provisions in the Treaty. It may be employed during an investigation or after a proceeding has already been initiated. Except for cases of organized crime, the offenses investigated must have dual criminality, that is, be criminal in nature in both the requesting and the executing states.

At consultations between the U.S. and Switzerland in Bern and Washington, D.C. in 1982, the parties agreed in principle to an exchange of diplomatic notes to facilitate the application of the Treaty to offenses which concern trading by persons in possession of material nonpublic information. 38/ Three specific

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38/ The fact that the Commission, which is an administrative agency, is investigating a potential insider trading violation would not preclude application of the Treaty, so long as its investigation is related to conduct which might be dealt with in a criminal proceeding. *See* Section 32(a) of the Securities Exchange Act, 15 U.S.C. 78ff(a).

antifraud provisions exist in the Swiss criminal law which arguably provide protection similar to the antifraud provisions of the Securities Exchange Act. While these provisions appear to be more restrictive than the U.S law concerning insider trading, they may apply under certain circumstances when a person trades while in possession of material nonpublic information.

The Treaty provides that the state granting assistance may refuse assistance to the extent that the request is likely to "prejudice its sovereignty, security or similar essential interests". Although bank secrecy may be considered an essential Swiss interest, generally, unless the person about whom the information is requested is unconnected with the offense, or the secret itself is of special importance to the Swiss economy, assistance will be granted under the Treaty. Assistance may also be refused if the request has been made for the purpose of prosecuting a person if that person already been acquitted on similar charges in the requested state.

Article 5 of the Treaty provides that information received pursuant to the Treaty, unless otherwise agreed by diplomatic note, must be used as evidence in a criminal proceeding before it can be introduced in a civil proceeding. This provision is the product of the tension which existed between the U.S. position that information furnished under the Treaty should be available for all uses, and the Swiss view that information gained under the Treaty should be used solely for the purpose

for which it was furnished. The Article accepts the Swiss view with respect to limitations on use, with certain exceptions. These exceptions allow for further use of the information, after the requested state is advised of such intended use, where the same subjects are involved. The article also provides for the use of the requested information by the governmental authorities in proceedings concerning "civil damages" or in any continuing criminal investigation covered by the Treaty, provided that such information is not introduced into evidence.

In the exchange of interpretive letters which accompanied the Treaty, the parties agreed that Article 5 is not "intended to restrict the use of information which has become public any more than the use of information which has become public would be restricted in the requested State." In addition, the parties agreed that the limitations of the Article constituted solely an agreement between governments, and could not be used on the part of any person to suppress or exclude any evidence gained under the Treaty. 39/

39/ Nevertheless, some criminal defendants have challenged production of such evidence as a violation of the Treaty. These challenges have been rejected by the courts. See, U.S. v. Johnpoll, 739 F.2d 702, 74 (2d Cir.), cert. denied, 469 U.S. 1075 (1984); U.S. v. Davis, 767 F.2d 1025, 1029 (2d Cir. 1985). The courts also have found the use of such evidence consistent with fairness and due process, since defendants retain the right to challenge the relevance of the evidence, U.S. v. Davis, 767 F.2d at 1030-33.

Under the Treaty, a request is handled between "Central Authorities," defined as the U.S. Justice Department and the Swiss Department of Justice and Policy. If a request is made to the U.S. and the U.S. Justice Department determines that the Treaty applies, the request will be immediately executed. This is not the case in Switzerland. Concurrently with the ratification of the Treaty, the Swiss passed additional implementing legislation which created specific rights of appeal for those who wish to oppose execution of U.S. Treaty requests. While this additional legislation does not bar the ultimate execution of the request, it has introduced significant time delays in the Treaty request process.

The SEC experience in using the Treaty has been limited, due to the general lack of dual criminality between the U.S. securities laws and the Swiss Penal Code. However, a recent exchange of opinions between the U.S. and Switzerland, and the Swiss Federal Tribunal's opinion in the Santa Fe (discussed below) and other cases, establish that the Commission may request and receive assistance in the area of insider trading from the Swiss.

Two insider trading cases, involving trading through Swiss bank accounts, were completed recently by the Commission using the Swiss Treaty. In SEC v. Certain Unknown Purchasers of the Common Stock of, and Call Options for the Common Stock of Santa

Fe International Corporation, et al., 81 Civ. 6553 (WCC) (S.D. N.Y., November 13, 1981) (the "Santa Fe" case), the Commission sought to learn the identities of certain accountholders who had directed purchases of Santa Fe stock and options through Swiss banks just prior to the announcement of a merger. The banks refused to answer on the ground that to do so would violate Swiss bank secrecy laws. On March 22, 1982, the Commission formally submitted a request for assistance under the 1977 Treaty to the government of Switzerland.

The Unknown Purchasers, utilizing Swiss procedures, opposed cooperation, and on January 26, 1983, the Swiss Federal Tribunal denied the Commission's request. The court accepted the facts as stated in the Commission's request and focused upon whether the allegations constituted a *prima facie* case of an offense for which assistance could be granted under the Treaty. 40/

The court concluded that the Commission had failed to establish the requisite violations of Swiss law. In particular, the court held that the facts as demonstrated in the Commission

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40/ The Federal Tribunal held that requests by the Commission could properly be processed under the Treaty, despite the fact that the Commission did not have the authority to prosecute them criminally. Because the securities laws may carry criminal penalties and because the Commission has the authority to refer a case for criminal prosecution, the Court held that the Commission's requests were in furtherance of an "investigation" in advance of a possible criminal referral, and thus could be processed under Article 1 of the Treaty.

request did not parallel the three Swiss criminal statutes that might relate to insider trading: harm to a person owed a contractual or legal obligation; fraud to procure personal gain by causing others to harm themselves; or abuse of a business secret by a party obligated to honor it.

The court noted that a person who uses to his advantage information that he is obligated to keep secret, without revealing it to a third party, may not be guilty of abuse of a business secret, since the secret had not been revealed and no profit was realized from the revelation. The Tribunal concluded that, while the trading in the Santa Fe case could violate Swiss law, because the Commission had been unable to allege whether the traders were insiders or tippees, the Tribunal could not make the requisite determination of dual criminality.

The court left open an avenue for a second request, based upon its analysis that while an "insider" could trade while in possession of the nonpublic information, a "tippee" who purchased stock would violate Swiss law. Accordingly, on July 27, 1983, the SEC alleged additional facts in support of its request for assistance under the Treaty.

On May 16, 1984, after all appeals were exhausted by the defendants, the Federal Tribunal, in an unpublished opinion, ruled that the new request adequately demonstrated that the traders were tippees, and not insiders. Accordingly, it granted

the Commission's request and the Commission learned the identities of the purchasers. However, just after these names were revealed, the purchasers appealed the ruling to prevent further disclosures of documents or testimony. This appeal to the Swiss Consultative Commission, the Swiss Justice Minister, and ultimately to the Swiss Federal Council, took nine additional months before it was finally resolved in favor of the Commission. The Commission ultimately received documents responsive to its request three years after its original request.

On February 26, 1986, all remaining defendants agreed to settle the Commission's action and disgorge $7.8 million in profits. Six of the eight defendants consented to the entry of Final Judgements of Permanent Injunction restricting each from future violations of the Securities Exchange Act. The remaining two defendants agreed to disgorge their profits from the transactions at issue.

Another recent example of the SEC's use of the Treaty for purposes of discovery in a suit involving insider trading arose out of SEC v. Banca Della Svizzera Italiana, et al., (see discussion of the St. Joe case, supra). In November 1986, the Swiss Federal Court considered an appeal by the subjects of a Commission request for information relating to trading by Guiseppe Tome and Lombardfin in the securities of St. Joe Minerals just prior to the announcement of a tender offer by Seagrams. The Court summarily dismissed the appeals to deny

assistance, confirming the fact that the Treaty applies to requests by the Commission where the dual criminality standard is met. No written opinion has been issued to date.

The Netherlands Treaty

The United States and the Kingdom of the Netherlands entered into a treaty providing for mutual assistance in criminal matters in August 1983. Unlike the 1977 Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States, this Treaty does not have a list of applicable offenses and does not generally require dual criminality. The "assistance" to be provided under the Treaty includes locating persons, serving judicial documents, providing records, taking testimony, producing documents, and executing requests for search and seizure. Assistance may be refused under the Treaty for political offenses or where execution of the request "would prejudice the security or other essential public interests" of the requesting state. Evidence and information obtained under the Treaty may not be used "for purposes other than those stated in the request," but this use restriction may be waived with the prior consent of the executing state.

The Turkish Treaty

The United States and Turkey entered into a treaty providing for mutual assistance in criminal matters in June 1979. That Treaty applies to all offenses which fall within the jurisdiction of judicial authorities of the requesting state. The

"assistance" provided for by the Treaty includes locating persons, serving judicial documents, and effecting the taking of testimony, the production of documents, and the service of process compelling the appearance of witnesses before a court of the requesting state. Assistance may be refused for political or military offenses or where the executing state considers execution of the request "likely to prejudice its sovereignty, security, or other similar essential interests." Use of materials obtained under the Treaty is limited to the purposes of investigations, criminal proceedings, and damage claims concerning the offense which is the subject of the proceeding or investigation in the requesting state.

The Italian Treaty

The Treaty Between the United States and the Italian Republic on Mutual Assistance in Criminal Matters provides mutual assistance in criminal investigations and proceedings concerning a broad range of offenses. A particularly significant aspect of this Treaty is that persons in the requested state may be required by the requested state to appear for testimony in the requesting state where the requesting state certifies that the testimony is relevant and material.

The Canadian Treaty

On March 17, 1985, Canada and the United States entered into a Treaty on Mutual Legal Assistance in Criminal Matters.

It provides for mutual legal assistance in all matters relating to the investigation, prosecution and suppression of criminal offenses. The Canadian Treaty does not require dual criminality and specifically provides for assistance with regard to securities offenses under Canadian Provincial law or the law of the United States. The "assistance" to be provided includes locating persons or objects, serving documents, taking testimony, providing documents and records, and executing requests for searches and seizures. A significant aspect of this Treaty is that there are virtually no limitations on the use of evidence obtained through its processes.

The Cayman Islands Treaty

On July 3, 1986, the United States entered into a Treaty with the Government of the United Kingdom of Great Britian and Northern Ireland and the Cayman Islands providing for mutual cooperation between the U.S. and the Cayman Islands in criminal investigations and prosecutions that involve offenses punishable by more than one year's imprisonment under the laws of either country. The Cayman Islands are a British Crown colony; therefore, this Treaty will not be effective until ratification by both the British Parliament and the U.S. Senate. The Treaty authorizes cooperation with respect to specific crimes, including but not limited to, insider trading, fraudulent securities practices, racketeering and failure to report international

currency transfers or financial transactions in connection with any criminal offense covered by the Treaty as required by law. Mutual assistance to be provided under the Treaty includes the taking of testimony, provision of documents, records, and articles of evidence, serving documents, locating persons and immobilizing criminally obtained assets.

The Treaty contains several limitations on assistance. For example, assistance will not extend to conduct not punishable by imprisonment of more than one year. Assistance also may be denied where the request does not establish that there are reasonable grounds for believing that the specified criminal offense has been committed, or where execution of the request is contrary to the public interest of the requested party.

3. Memoranda Of Understanding

The Swiss Memorandum

On August 31, 1982, the governments of Switzerland and the U.S. announced the signing of a Memorandum of Understanding (MOU) with respect to problems of insider trading. The MOU recognizes the availability of the 1977 Mutual Assistance Treaty for insider trading litigation and investigations. For those cases in which necessary information cannot be obtained under the Treaty, however, the MOU refers to a private agreement among members of the Swiss Bankers' Association who trade on U.S. securities markets concluded under the aegis of the Swiss Bankers' Association.

Under the MOU the signatory banks, under certain circumstances, may disclose the identity of a customer and furnish information to the Commission, working through the Swiss Federal Office for Police Matters, without violating Swiss law. The private agreement, known as Convention XVI of the Swiss Bankers' Association, will remain in effect until the Swiss government revises its penal and civil laws to include insider trading. Such efforts are presently under way, and legislation has been presented to the Swiss Parliament.

The private agreement provides that its procedures will be available if, within 25 trading days prior to a public announcement of a proposed merger, similar business combination, tender offer or other acquisition, a customer gives to a bank an order to be executed in the U.S. securities markets for the purchase or sale of securities or call options or put options for securities of any company that is a party to a business combination or the subject of an acquisition. Under such circumstances the Commission may transmit a request for assistance to a three-member commission of inquiry appointed by the Swiss Bankers' Association. The Swiss commission will examine the request and determine whether certain basic thresholds are met and whether sufficiently suspect circumstances are presented.

Upon receipt of the request from the Swiss commission, the bank will freeze the relevant customers' accounts up to the amount of the profit realized in the transaction, inform the

customer, and give the customer an opportunity to respond to the allegations contained in the request. Within 45 days, the bank will then forward the requested report to the Swiss commission. The Swiss commission then forwards the report to the Federal Office for Police Matters for transmission to the SEC. In the event that the bank's report establishes, or the customer independently establishes, to the reasonable satisfaction of the Swiss commission, that the customer did not make the purchases or sales that are the subject of the SEC's request, or if the commission determines that the customer is not an insider under a definition provided in the private agreement, 41/ the Federal Office for Police Matters will not transmit the report to the SEC.

The MOU provides that information gained pursuant to the private agreement can be used only by the SEC and the Department of Justice and will not be disclosed "to any other administrative body in the United States or to the public, except to the extent necessary for administrative or judicial purposes of the specific case."

41/ The private agreement defines an insider as a member of the board, an officer, an auditor or a mandated person of the company or an assistant of any of them; or (b) a member of a public authority or a public officer who in the execution of his public duty received information about the company; or c) a person who on the basis of information about an Acquisition or a Business Combination received from a person described in (a) or (b) above, has been able to act for the latter or to benefit himself from inside information.

The Commission recently used the MOU, for the first time, in a civil action. Securities and Exchange Commission v. Harvey Katz, Marcel Katz, Elie Mordo, and Fred Aizen, Civil Action No. 86 Civ. 6088 (S.D.N.Y., 1986), involved allegations of insider trading in the securities of RCA Corporation. The Commission's complaint alleged that Marcel Katz obtained material, nonpublic information relating to a merger between RCA and the General Electric Company in the course of his employment as an analyst at Lazard Freres & Co. Marcel Katz, it was alleged, subsequently disclosed this information to his father, Harvey Katz. The complaint further alleged that Harvey Katz disclosed this information to Elie Mordo, who resides abroad, and Fred Aizen, Katz's stockbroker. Mordo allegedly purchased 100,000 shares of RCA stock through a Swiss bank, Union Bank of Switzerland.

The Commission used the 1982 Memorandum of Understanding between the United States and Switzerland and Convention XVI of the Swiss Bankers' Association to identify defendant Mordo as the purchaser of RCA common stock through the Geneva office of the Union Bank of Switzerland. The Commission's request was reviewed by the Bankers' Association, the Swiss Federal Tribunal (Swiss Supreme Court) and the Swiss Federal Council, all of which affirmed the Commission's right to obtain the evidence sought. During these deliberations, the profits which Mordo later disgorged in the U.S. civil action were frozen pending a final resolution of the case in Switzerland.

In consenting to injunctions, Harvey Katz agreed to disgorge $1,035,425 and to pay a civil penalty of $2,111,168 pursuant to the Insider Trading Sanctions Act of 1984. Marcel Katz agreed to pay a civil penalty of $173,891 under the ITSA. Mordo consented to disgorgement of $1,087,532 and Aizen consented to pay $60,000 and to pay a civil ITSA penalty of $20,000.

The assistance available through the Convention, and the mechanism for obtaining that information, is specifically tailored to the securities enforcement issue it was negotiated to address: insider trading. While the Convention is limited to certain types of insider trading and provides only specified assistance, it has been effective, as evidenced by the speed with which assistance was furnished in the Katz case (approximately seven months). Because it is applied by a Swiss commission which is sensitive to both the needs of the SEC and the privacy concerns of a bank customer, it can produce a disinterested view of the evidence, reducing the ability of a party to abuse the process.

Case-by-case Agreements

Where the Commission must seek evidence from countries with which no formal understanding has been negotiated, it may approach the government of that country through the U.S. State Department, requesting assistance for a particular case. While this case-by-case approach is not optimal, it provided the Commission with evidence in one of its most important cases.

In <u>In the Matter of Guaranty Trust Co. Ltd.</u>, Supreme Court of the Bahamas No. 423 (May 22, 1985), the Commission sought a court order requiring the production of evidence relating to the identity of customers of a Bahamian bank who had purchased securities just prior to a merger announcement. The Commission argued that a securities transaction was not a banking transaction pursuant to Bahamian law and that therefore the Bahamian secrecy law should not be applied to shield the customers' identity. The case was dismissed on the ground that the Commission's action sought an advisory opinion. On July 4, 1986, the Commonwealth of The Bahamas Court of Appeal affirmed the dismissal of the SEC's case for lack of standing.

While this attempt to obtain a court order for release of the information in the Guaranty Trust case was unsuccessful, it laid the groundwork for success in one of the Commission's largest insider trading cases to date, <u>SEC v. Dennis Levine, et al.</u>, 86 Civ. 3726 (RO) (S.D.N.Y. 1986). In that case, the Commission's enforcement staff worked with the Bahamas Attorney General to obtain documents from Bank Leu International ("BLI"), a financial institution located in the Bahamas, that arguably were shielded from disclosure under the Bahamian bank secrecy laws. BLI turned over the requested information to the Commission after the bank received written assurances from the Bahamas Attorney General that criminal penalties would not result from a release of documents pertaining to Levine's securities transactions. The information from BLI greatly assisted the Commission

in its civil case against Levine, who settled the action by consenting to a permanent injunction against future violations of the federal securities laws, and by agreeing to disgorge $11.6 million and to cooperate with the Commission in related investigations.

The U.K. Memorandum

On September 23, 1986, the Commission and the Commodity Futures Trading Commission entered into a Memorandum of Understanding with the U.K. Department of Trade and Industry which, on a reciprocal basis, will provide assistance in obtaining records that are in the hands of the other, or that can be obtained through the best efforts of the parties to the MOU.

The U.K. MOU is intended to enhance international enforcement of both countries' securities laws by providing assistance for investigations of violative conduct within each authority's jurisdiction as well as for regular market oversight. Specifically, the MOU makes assistance available in matters involving insider trading, market manipulation and misrepresentations relating to market transactions. The MOU also provides for exchange of information in matters relating to the oversight of the operational and financial qualifications of investment businesses and brokerage firms.

The U.K. MOU is the first accord negotiated by the Commission that provides assistance for a broad range of matters relating

to market conduct and regulation of investment businesses. Use of the information received under the agreement is generally limited to prosecuting securities offenses or to a general charge (i.e., mail and wire fraud) related to an underlying securities law violation.

The U.K. MOU provides special safeguards to ensure that assistance is properly invoked. Requests must be made with particularity. When questions arise as to the MOU's operation, consultations between the parties are mandated by the agreement. Finally, at the conclusion of the matter in question and to the extent permitted by law, all documents not previously made public will be returned to the other authority.

The U.K. MOU establishes the first working arrangement between securities regulators in the U.S. and the U.K. It is an interim arrangement which both parties describe as a first step in their efforts to establish a comprehensive understanding to provide bilateral cooperation relating to securities regulation. The MOU expressly provides for the initiation of negotiations by September 22, 1987.

The Japanese Memorandum

On May 23, 1986, the Commission and the Securities Bureau of the Japanese Ministry of Finance executed a memorandum in which the agencies "agreed to facilitate each agency's respective requests for surveillance and investigatory information

on a case-by-case basis." The memorandum appointed a specific contact person in each agency to ensure timely processing of requests.

The Hague Convention

In addition to arrangements with individual countries, the Commission has used the Hague Convention on the Taking of Evidence Abroad. Although the Treaty encompasses three of the most common devices for foreign discovery: letters rogatory, evidence-taking by a counsular official, and private commissioners, these methods have been of limited utility to the Commission. The Hague Convention can only be used in connection with litigation, and not investigations. Moreover, most of the signatory nations have exercised their prerogative, under Article 23 of the Hague Convention, to refuse to execute letters rogatory for the purpose of pre-trial discovery of documents. 42/

42/ On February 10, 1987, however, France modified its declaration regarding Article 23 as follows:

> The declaration made by the French Republic in accordance with Article 23 relating to Letters of Request issued for the purpose of obtaining pre-trial discovery of documents does not apply when the requested documents are enumerated limitatively in the Letter of Request and have a direct and precise link with the object of the procedure. (Translation)

Even where the Hague Convention is available for pretrial discovery of testimony, the requester must establish that the requested evidence is "relevant" to trial. This is a burden which is often difficult to meet at the early stages of U.S. litigation, where the evidence sought is not necessarily direct evidence which proves violative conduct, but rather, evidence which may lead to such proof.

In the Santa Fe case, discussed supra, the Commission sought documents and testimony pursuant to the Hague Convention from third parties resident in London. These third parties included a hotel, a credit card company and two individuals who had acted as stockbrokers for purchasers of Santa Fe securities just prior to the announcement that Santa Fe had agreed to merge with Kuwait Petroleum Corporation. The hotel, credit card company and individuals had all refused to provide the evidence voluntarily on the grounds that without a court order or subpoena they owed a duty of confidentiality to their customers.

The Commission sought and received letters rogatory in a U.S. court seeking assistance from England pursuant to the Hague Convention. Upon presentation of this request, an English Master granted the Commission's request and ordered the evidence to be given. Accordingly, the credit card company and hotel produced the documents sought. However, the two individuals refused, arguing that the request was improper under the terms of the Hague Convention and that should they give testimony,

they would violate the Luxembourg bank secrecy law because, at the time the purchases were made, they were employees of a London-based Luxembourg bank.

Seven months later, after extensive briefing and four days of oral argument, the High Court of Justice, Queens Bench Division, ordered the two individuals to testify. Reprinted in: 34 Int'l Legal Materials 511 (1984). The court held that the information was relevant, based upon affidavits submitted by the Commission, and that it was sought for a civil prosecution, as provided for in the Foreign Evidence Act. The court refused to give effect to the Luxembourg privilege which had no parallel in British law. Finally, the court held that British bank secrecy laws would not apply because, based on the facts of the case, such an application would not be in the public interest.

Athough the Commission was ultimately successful in obtaining the requested evidence, the British Santa Fe application for letters rogatory cost the SEC thousands of dollars in staff time and fees paid to foreign counsel and took nine months to complete.

The Commission also used the Hague Convention to gather evidence for trial of the Sante Fe case from a central witness residing in France who, the Commission had learned, had been with a defendant at or near the time that the defendant had traded Santa Fe securities. In the Matter of the testimony

<u>of Costandin Nasser</u>, Tribunal admin. de Paris, 6'eme section - 2'eme chamber, No. 51546/6, December 17, 1985.

The Commission initiated the process on June 2, 1983, by motion to a U.S. district court for issuance of letters of request under the Hague Convention for assistance from the courts of France. The Commission's motion was granted and the subsequent request was granted by the French Ministry of Justice on August 26, 1983. Upon granting the request, the Ministry of Justice transmitted it to a civil investigating judge who was authorized to gather the requested evidence.

On January 18, 1984, the civil judge who had received the Commission's letter of request convened a hearing on the execution of the request. However, as the witness did not appear, the Commission sought imposition of a fine. The judge reserved ruling on this question, stating that he would have the witness served again for a further hearing. The witness then filed a brief ("recours gracieux") with the French Ministry of Justice protesting the procedure by which his evidence was being sought and requesting an administrative review of the Ministry of Justice's decision to transmit the request. Thereafter, on September 26, 1984, the Ministry of Justice confirmed its initial decision and instructed that the proceedings go forward.

On January 25, 1985, a second proceeding was held at which time the witness appeared though counsel. In the meantime,

however, the witness had filed a "recours contentieux" (request for review by an administrative court) against the initial decision by the Ministry of Justice to transmit the letters of request, as well as its confirmation on September 26, 1984. Since such a request did not stay the action, the Commission again sought imposition of a fine against the witness for his failure to appear. The civil judge again deferred this decision for consideration at a time after the administrative court ruled.

On December 17, 1985, the Administrative Court confirmed the Commission's right to obtain the evidence sought under the Hague Convention. However, by that time the Commission was engaged in settlement negotiations and it was determined that the request should not be pursued. The underlying enforcement action was resolved by entry of a consent injunction on February 26, 1986.

In SEC v. Banca Della Svizzera Italiana, 81 Civ. 1836 (MP)(S.D.N.Y.), the SEC sought documents and testimony pursuant to the Hague Convention in Italy and Guernsey. The U.S. district court issued letters rogatory to the Ministry of Foreign Affairs of Italy requesting the production of documents by an SEC registered broker-dealer located in Milan, Italy, and certain individuals affiliated with that broker-dealer. By decree of the court of appeals of Milan, dated September 10, 1985, the letters rogatory were authorized and directed to be carried out on October 2, 1985.

At the proceedings in the Praetor's Court of Milan, lawyers for the witnesses objected to the letters rogatory, arguing that the pending action in the U.S. was an administrative proceeding, not a civil action, and, therefore, that the letters rogatory did not comply with the Hague Convention. The Praetor concluded that the U.S. proceeding was a civil action, as required by the Hague Convention, and ordered the implementation of the letters rogatory. The witnesses then responded to questions put by the Praetor. The Praetor, however, refused to compel the witnesses to produce the requested documents because under the Italian law implementing the Convention such compulsion is unavailable. Nonetheless, he "invited" the witnesses to produce the requested documents.

The U.S. district court also issued letters rogatory to the Bailiwick of Guernsey, Channel Islands, requesting the production of documents and the testimony of an individual employed by a Guernsey banking institution. By order of the Guernsey Court, the witness was to appear and produce documents. On October 7, 1985, the witness filed a motion to set aside the order, arguing that the U.S. proceeding was administrative and not civil and that request was for pre-trial discovery and thus not allowed in accordance with Guernsey's reservations to the Hague Convention. On March 11, 1986, the Deputy Bailiff of Guernsey denied the Commission's request for assistance on the grounds that because the Commission sought testimony relating

to identities of persons involved in securities transactions, the inquiry was a "fishing expedition." On April 10, 1986, the Commission appealed this order. On July 15, 1986, upon motion by the Commission, this matter was dismissed as moot in view of the fact that the Commission had prevailed in the underlying U.S. litigation.

Thus, while the Hague Convention has proven useful, its procedures are costly and time consuming. As a result, the Commission's enforcement staff prefers to use specific bilateral and multilateral mutual assistance agreements or memoranda of understanding. Thus, the Supreme Court's decision this term in Societe Nationale Industrielle Aerospatiale and Societe de Construction d'Avions de Tourism v. United States District Court for the Southern District of Iowa, 94 L.Ed 2d 461 (1987), is significant for the Commission. In this case, the Supreme Court held that the Hague Convention does not provide the exclusive mechanism for obtaining evidence located abroad. Moreover, even where it is asserted that American discovery methods would violate a foreign nation's law or policies, principles of comity do not require that the Hague Convention be the mechanism of first resort to obtain evidence abroad. Rather, comity requires the courts to consider the availability of the Hague Convention as an alternative means of obtaining discovery and to attempt to accommodate the foreign interests giving due regard to the likelihood that the Convention will produce efficient and effective discovery under

the circumstances of the particular case. 43/ The Court's opinion is consistent with the position taken by the Commission and the United States as amici curiae.

4. Other Initiatives

Outside of particular agreements, the Commission participates in several groups concerned with the internationalization of the securities markets and attendant enforcement problems. The Commission is a member of the International Organization of Securities Commissions ("IOSC"). The IOSC was established over eleven years ago as the Inter-American Association of Securities Commissions and Similar Organizations. In an effort to facilitate discussion among a broader base of securities regulators, the Organization has expanded its membership to include regulators from all over the world. At the suggestion of former SEC Chairman Shad, the IOSC at its 11th annual meeting in July

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43/ Many countries are not signatories to the Hague Convention so that the Commission must use letters rogatory, a more formal request for assistance, to obtain evidence. Such a procedure is used when seeking evidence from Canada. For example, in SEC v. Cayman Islands Reinsurance Corp., 82 Civ. 1166 (WCC), S.D.N.Y. and R.E. 2792/82 (S. Ct. Ont. (Oct. 25, 1982), see also, 551 F. Supp. 1056 (S.D.N.Y. 1982), the Supreme Court of Ontario executed letters rogatory issued by the federal district court in New York, requiring a witness to appear before a Canadian Examiner to be deposed by U.S. counsel and to produce subpoenaed documents. However, the Ontario court order stated that while the examination would be conducted in accordance with U.S. rules of evidence, the witness remained entitled to invoke objections under the Ontario and Canada Evidence Acts.

set up five working groups in the following areas:

1. Exchange of information concerning the enforcement of the securities laws;

2. Acceleration of clearing and settlement systems;

3. Access of foreign issuers, brokers-dealers, and investors to national markets;

4. Growth of developing nations' securities markets; and

5. Modernization of prospectuses.

The Commission chairs the working group relating to the exchange of enforcement information.

In November of 1986, the Executive Committee of the IOSC adopted a Commission proposal relating to cooperation among securities commissions. That resolution provides:

> Considering the increasing international acvitity in the securities markets;
>
> Recognizing the need to enhance investor protection through both oversight of the internationalized markets and securities-related businesses as well as through enforcement of national securities laws with respect to international transactions;
>
> Desiring to develop new mechanisms for mutual cooperation and assistance among securities authorities;
>
> NOW THEREFORE BE IT RESOLVED THAT the Executive Committee of the International Organization of Securities Commissions ("IOSC") hereby calls upon all securities authorities:
>
> a) to the extent permitted by law, to provide assistance on a reciprocal basis for obtaining information related to a market oversight and prosecution of each nation's markets against fraudulent securities transactions;

b) to designate a contact person(s) who will insure the timely processing of all requests for assistance.

The resolution has now been submitted to the membership for consideration.

The Commission has also been a participant in matters at the Organization for Economic Cooperation and Development ("OECD"), including discussions relating to international evidence gathering and an examination of obstacles faced by foreign organizations seeking to participate in the financial services industry. Last fall the Commission proposed that the OECD Working Group on International Investment Policies of the Committee on International Investmesnt and Multinational Enterprises initiate a survey of all member countries concerning mutual assistance and cooperation in securities enforcement matters. The first phase of this program, the circulation of a questionnaire, is currently under way. The information gathered through this process should prove useful in continuing efforts to develop new mechanisms in the area of mutual legal assistance.

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